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IN THE SUPERIOR COURT OF THE STATE OF ARIZONA

IN AND FOR THE COUNTY OF MARICOPA

ESTATE OF HELEN H. LADEWIG, on behalf of itself and the class of all persons in the State of Arizona who, during any one of the years 1986 to 1989 paid income taxes to the State of Arizona on dividends paid by corporations whose principal business was not attributable to Arizona, et al., Plaintiffs vs. ARIZONA DEPARTMENT OF REVENUE and its Director, in his official capacity, Defendants.	**No. TX 97-00075** (Assigned to the Honorable Paul A. Katz)

PLAINTIFFS' COMBINED REPLY MEMORANDUM IN SUPPORT OF THE COMBINED MOTIONS FOR AN ORDER DETERMINING THE DEPARTMENT'S LACK OF STANDING, ETC.

Rather than file two separate Reply Memoranda of up to 10 pages each as permitted by Local Rule 3.1(f), Plaintiffs have combined the two Reply Memoranda in a single Combined Reply to eliminate repetition and ease the burden on the Court.

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TABLE OF CONTENTS

I. PRELIMINARY STATEMENT — THE STATE SEEKS STANDING IT KNOWS IT DOES NOT HAVE IN ORDER TO PRESENT ARGUMENTS IT KNOWS ARE NOT APPLICABLE HERE.

In this common fund case, which the State voluntarily settled, the State is not paying any of the costs of administration or Class Counsel's attorneys' fees.[1] The State therefore has no economic interest whatsoever in the determination of Class Counsel's fee request, which the Department has already publicly conceded is "**fair**."

Regardless, the State still seeks standing to challenge Class Counsel's fee award by arguing that Arizona law requires the Court in this common fund case to use a lodestar approach as set forth in *Schweiger v. China Doll Restaurant, Inc.* — the approach used when fees are being shifted to a losing party pursuant to contract or statute.[2] However, the State has failed to disclose to this Court that the State's assertions of law here are **exactly the opposite of** what the State has just told our Court of Appeals in the case of *Burke v. Arizona Retirement Systems*, 2 CA-CV02-0035, argued this month. In that case, in which the State is responsible in contract for paying the Plaintiff Class' attorneys' fees and seeks to have fees awarded pursuant to the lodestar "fee-shifting" method, the State admitted that all of the legal arguments it seeks to make here have no applicability in a common fund fee-spreading or fee-sharing situation. The State also admitted it has no standing to be heard under the facts of our case when it told the Court of Appeals:

> **Because a fee award under the common-fund doctrine spreads the fees to the beneficiary class, not the defendant, the defendant has no interest in the fee award.** *Boeing Co.*, 444 U.S. at 481-82, 100 S.Ct. at 751; *Petroleum Prods. Antitrust Litig.*, 109 F.3d at 608; *Brown v. Phillips Petroleum*, 838 F.2d at 456; Report of the Third Circuit Task Force, *Court Awarded Attorney Fees*, 108 F.R.D. 237, 251 (1985); *Knight*, 982 F.2d at 1579; ***Kerr*, 197 Ariz. at 217, ¶ 16, 3 P.3d at 1137.**

State's Opening *Burke* Brief at pp. 19-20 (emphasis added) (included as part of Exhibit 2 hereto).

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[1]The Department is a division of the State, and will be referred to herein as either the State or the Department.

[2]Excerpts from the State's "Motion to Set Deadlines to Substantiate Attorney Fee Request" ("Department's Motion") and its current Response confirming that this is the legal argument sought to be presented, are set forth on Exhibit 1 hereto.

Moreover, the State has further failed to inform this Court that the primary case it relies upon for the argument it seeks standing to present, *In Re: Washington Pub. Power Supply Sys. Sec. Litig.*, 19 F.3d 1291, 1305 (9th Cir, 1994)("*WPPSSS*"), directly ruled against the State's position on the very standing issue that is now before this Court:

> Thus, the concerns expressed in *Dague* about unduly burdening losing parties in statutory fee cases are not present in common fund cases where fees are paid out of the settlement fund. **How the fund is divided between members of the class and class counsel is of no concern whatsoever to the defendants who contributed to the fund.**

WPPSSS, 19 F.3d at 1301 (emphasis added).

In short, the State has failed to disclose to this Court that it both knows and agrees it has no standing to be heard here — and that the legal argument it wishes to present is inapplicable. The omissions constitute more than sharp tactics. Rule 42, RULES OF THE ARIZONA SUPREME COURT, E.R. 3.3 (Candor Toward the Tribunal) provides in relevant part:

> (a) A lawyer shall not knowingly:
>
> (i) Make a false statement of material fact or law to a tribunal;
>
> * * *
>
> (iii) Fail to disclose to the tribunal legal authority in the controlling jurisdiction known to the lawyer to be directly adverse to the position of the client and not disclosed by opposing counsel . . .

As explained by the comment to E.R. 3.3:

> **Misleading Legal Argument**
>
> Legal argument based on a knowingly false representation of law constitutes dishonesty toward the tribunal.

As will be shown, the State's Response and its false assertions to this Court that the legal authority it seeks to present is applicable in a common fund case, constitute a patent violation of E.R. 3.3, and serves as a further basis, independent of the four grounds set forth in Class Counsel's Motion, to deny the Department standing. Even if the Department otherwise had standing here, which it does not, its lack of candor to this tribunal would be a sufficient basis to preclude it from participating further.

II. THE STATE'S MISREPRESENTATION OF ARIZONA LAW TO THIS COURT DEMONSTRATES ITS LACK OF STANDING.

In its Combined Motion, Class Counsel conclusively established four dispositive legal grounds which exclude the State from interfering with a fee award that the State is not paying in a common fund case the State voluntarily settled. For each of the reasons discussed below, there is now a fifth dispositive legal ground — the Department's misrepresentation of the law to this Court.

A. THE STATE'S ASSERTION OF STANDING HERE IS REFUTED BY ITS RECENT ACCURATE REPRESENTATION OF THE CONTROLLING ARIZONA LAW TO THE COURT OF APPEALS.

Although the Department – which is a division of the State – claims it has standing here to interfere with Class Counsel's fee award even though it is not paying the award, that is not what the State told the Arizona Court of Appeals in its briefs and at oral argument on November 6, 2002, when the State was attempting to avoid a fee award it had voluntarily agreed to pay. In fact, in *Burke* v. *Arizona State Retirement System,* 2 CA-CVO2-0035, the State admitted the very point it is contesting here, and it is bound by that judicial admission here. *See* Exhibit 2 hereto.

In *Burke,* a class action seeking damages concerning the administration of the Arizona State Retirement System, the State agreed as a term of the settlement to pay the plaintiffs' attorneys' fees. The plaintiffs contended the fees were to be measured as a percentage of the common fund created by the settlement, and the trial court agreed, awarding the plaintiffs' counsel 16.6 % of the common fund. Although the trial court subsequently lowered the percentage, the State still objected, claiming it was not low enough. On appeal, the State argued that the Court must use the lodestar method when the fees are being shifted to the losing party.

In its explanation of the legal difference between a case where fees are shifted to a losing party and a situation where, as here, they are being shared among the beneficiaries of the fund,

the State argued to the Court of Appeals as controlling Arizona law the very legal principle the State contests here:

> **Because a fee award under the common-fund doctrine spreads the fees to the beneficiary class, not the defendant, the defendant has no interest in the fee award.** ***Boeing Co.***, 444 U.S. at 481-82, 100 S.Ct. at 751; ***Petroleum Prods. Antitrust Litig.***, 109 F.3d at 608; ***Brown v. Phillips Petroleum***, 838 F.2d at 456; **Report of the Third Circuit Task Force,** ***Court Awarded Attorney Fees***, 108 F.R.D. 237, 251 (1985); ***Knight***, 982 F.2d at 1579; ***Kerr*****, 197 Ariz. at 217, ¶ 16, 3 P.3d at 1137.**

State's Opening *Burke* Brief, at pp 19-20. (Emphasis added).[3] In fact, as this Court can see, the State cited to the Court of Appeals most of the same cases Class Counsel has cited in its Combined Motion for the same rule of law, including *Kerr III*!

The State of Arizona, represented by the same attorneys, simply cannot argue the exact same legal authorities mean two totally opposite things, at the same time, to two separate courts of this State. The Comment to E.R. 3.3, "Candor to the Tribunal," states: "[l]egal argument based on a knowingly false representation of law constitutes dishonesty toward the tribunal." *See also* David D. Dodge, *Candor to Court and Client*, ARIZONA ATTORNEY, June 2001, at 14 ("[A]ll lawyers have a duty to candidly present to the court pertinent controlling legal authority bearing on the issues at hand.").

Given the State's specific recognition in *Burke* that the controlling precedent means exactly what Plaintiffs say it does, the State cannot assert that Arizona law is the opposite here. But even if the State could escape its admission, its presentation in *Burke* reveals that it knows that which it denies here, and reveals its true motive for seeking standing here – to compromise Class Counsel's independence and to hamper Class Counsel's ability to vigorously represent the class members in the future.

The State's dissembling further underscores Professor Silver's conclusion: the State is no friend of the taxpayers here and should not be heard further. As Professor Silver explains in his Declaration, in this Rule 23 case, where due process considerations are critical, such result is

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[3] Interestingly, many of the policy factors urged by the State in *Burke* as to the significant differences between a common fund fee award and a fee shift award are fully in accord with the expert opinion of Professor Silver. Compare the portion of the State's Brief in *Burke* quoted in Section IIB, *infra*, with Professor Silver's Opinion, Exhibit B to Plaintiffs' Combined Motion. Thus, it is now clear that the only position in this case that is actually contrary to Arizona and Ninth Circuit Law is the State's position in its Response filed herein.

required. The State's lack of candor with this Court also underscores former Chief Justice Zlaket's conclusion that it would be improper to allow the Department to participate under these facts, and unethical for its lawyers to do so under any scenario.

B. THE STATE ALSO FAILED TO DISCLOSE TO THIS COURT THAT THE PRINCIPAL FOREIGN JURISDICTION AUTHORITIES IT HAS RELIED UPON REJECT THE STATE'S STANDING HERE.

The very cases the Department relies upon establish the Department has no standing here. For example, the Department's Motion contains 25 case citations for its lodestar/time records argument, ten of which are to Ninth Circuit cases. Four of the Ninth Circuit citations are to *WPPSSS*, in which the Court reversed the district court's initial fee award because it had failed to apply a risk enhancement (on remand, the district court awarded counsel between 12 to 14% of an approximately $687 Million fund). However, the Department did not inform this Court that the Ninth Circuit in *WPPSSS* expressly considered the differences between fee shifting cases (such as those cited in the Department's Motion) and fee sharing or fee spreading cases (such as this one), and stated the rule of law the Department seeks to violate here — that a defendant has no standing to contest a fee award it is not paying:

> Thus, the concerns expressed in *Dague* about unduly burdening losing parties in statutory fee cases are not present in common fund cases where fees are paid out of the settlement fund. **How the fund is divided between members of the class and class counsel is of no concern whatsoever to the defendants who contributed to the fund.**

WPPSSS, 19 F.3d at 1301 (emphasis added).

The Court in *WPPSSS* also underscored the important policy distinctions between fee shifting cases and common fund fee sharing cases, critical distinctions that compel the use of enhancements in common fund cases. The Department, however, has studiously avoided disclosing to this Court the directly relevant policy distinctions taught by the very cases it relies upon. Such omission again reveals the Department's true intent in attempting to be heard here – to drive down the award as far as possible in order to discourage Class Counsel from zealously representing the class members during the four year refund process. In *WPPSSS*, the Court explained:

> It is an established practice in the private legal market to reward attorneys for taking the risk of non-payment by paying them a premium over their normal hourly rates for winning contingency cases. *See* Richard Posner, *Economic Analysis of Law* § 21.9, at 534-35 (3d ed. 1986). Contingent fees that may far exceed the market value of the services if rendered on a non-contingent basis are accepted in the legal profession as a legitimate way of assuring competent representation for plaintiffs who could not afford to pay on an hourly basis regardless whether they win or lose. *See Model Rules of Professional Conduct* Rule 1.5(a)(8) (1992); *Model Code of Professional Responsibility* DR 2- 106(B)(8) (1980); *Canons of Ethics* § 12, 33 A.B.A.Rep. 575, 578 (1908).

Id. at 1299-1300.[4]

The Court then underscored a critical concern present in a common fund case that is not present in a situation where fees are being shifted to the losing party:

> Unlike statutory fee-shifting cases, where the winner's attorneys' fees are paid by the losing party, attorneys' fees in common fund cases are not paid by the losing defendant, but by members of the plaintiff class, who shoulder the burden of paying their own counsel out of the common fund. *See Boeing Co. v. Van Gemert*, 444 U.S. 472, 478-79, 100 S.Ct. 745, 749, 62 L.Ed.2d 676 (1980); *Vincent v. Hughes Air West, Inc.*, 557 F.2d 759, 769-70 (9th Cir.1977). There is nothing unfair about contingency enhancements in common fund cases because of the equitable notion that those who benefit from the creation of the fund should share the wealth with the lawyers whose skill and effort helped create it. *Boeing*, 444 U.S. at 478, 100 S.Ct. at 749; *Graulty*, 886 F.2d at 271. As the Seventh Circuit observed in *Skelton v. General Motors Corp.*, 860 F.2d 250, 254 (7th Cir.1988), "in the common fund context, attorneys whose compensation depends on their winning the case, must make up in compensation in the cases they win for the lack of compensation in the cases they lose."

Id. at 1300-1301.

However, in its Response, the State now seeks standing to argue the opposite result: it asks this Court to focus only on Class Counsel's hours in this case to date (simply ignoring all the risks and all the future hours and costs), claiming that using the percentage method will somehow result in a "windfall" and must be avoided **despite the fact that the percentage method is now the favored method in almost all jurisdictions, state and federal.**

The State's briefs in *Burke* further confirm that its inconsistent assertions here are not inadvertent or benign because in *Burke*, where the State was attempting to convince the Arizona Court of Appeals that *Burke* was a "fee shifting" case, the State unambiguously recognized the

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[4] Contrary to the Department's assertions, Professor Silver's expert opinion is based upon detailed studies of virtually identical market and ethical considerations as those considered by the Ninth Circuit in *WPPSSS*.

policy distinctions it now asks this Arizona Tax Court to ignore. The following lengthy quote from the State's *Burke* brief establishes this point beyond dispute:

> **"Strong Policy Reasons Support Using the Lodestar Rather Than the POF [*i.e.* Percentage of Fund] Method in Statutory Fee-Shifting Cases.**
>
> Choosing whether to apply the lodestar or POF is much more than just a matter of form. There are compelling economic and policy reasons for not applying the same methodology for determining the amount of a fee-shifting award as for determining the amount of a fee-sharing award:
>
> > In *Dague*, the Court held that the private market's model of paying premiums for the risk of non-payment was inapplicable in statutory fee-shifting cases. For a variety of reasons, the Court concluded that the private market practice of rewarding attorneys for taking cases on a contingency basis would unduly burden losing parties who are required by statute to pay no more than a "reasonable" fee for the services rendered by the winning party's attorneys in that particular case. *Dague*, 505 U.S. at 562-63 112 S.Ct. At 2641. For example, the Court reasoned that it would be incompatible with fee-shifting statutes to burden losing parties with a contingency enhancement that has the effect of compensating the winning attorneys for time gambled away in the contingency cases they lose:
> >
> > > An attorney operating on a contingency-fee basis pools the risks presented by his various cases: cases that turn out to be successful pay for the time he gambled on those that did not. To award a contingency enhancement under a fee-shifting statute would in effect pay for the attorney's time (or anticipated time) in cases where his client does *not* prevail.
>
> *Id.* At 565, 112 S.Ct. At 2643 (emphasis in original). This concern, along with concern over the complexity and cost of administering a system of contingency enhancements in the statutory fee context, drove the Court to the conclusion that "[i]t is neither necessary nor even possible for application of the fee-shifting statutes to mimic the intricacies of the fee-paying market in every respect." *Id.*
>
> WPPSS, 19 F.3d at 1300 (footnote omitted). The same concerns do not necessarily apply in a true common-fund doctrine case:
>
> > There is nothing unfair about contingency enhancements in common fund cases because of the equitable notion that those who benefit from the creation of the fund should share the wealth with the lawyers whose skill and effort helped create it. [I]n the common fund context, attorneys whose compensation depends on their winning the case, must make up in compensation in the cases they win for the lack of compensation in the cases they lose.
> >
> > Thus, the concerns expressed in *Dague* about unduly burdening losing parties in statutory fee cases are not present in common fund cases where fees are paid out of the settlement fund. How the fund is divided between members of the class and class counsel is of no concern whatsoever to the defendants who contributed to the fund. In a common fund case, where there is no direct or immediate danger of unduly burdening the defendant, a

> court has more latitude in exercising its equitable powers to determine whether the plaintiff class should compensate its attorneys for their risk of nonpayment. ... [W]e find *Dague's* reasoning inapposite in the common fund context. . . ."

WPPSS at 1300-01 (9th Cir. 1994) (punctuation, citations and footnote omitted)." [State of Arizona Opening Brief in *Burke*, pgs 36-38; Exhibit 2 hereto.]

It is patent the State has acknowledged to the Court of Appeals the validity of the policies justifying use of the percentage award in a common fund case. Yet the State seeks standing here to urge use of a fee award method contrary to the policy of the law.[5] It seeks to do so even though it has admitted the requested percentage is "**fair**." As Mr. Zlaket concludes, the Department's input on Class Counsel's fees is neither warranted nor appropriate. Simply put, since at least the time of Aesop's fables, the fox's offers to guard the henhouse have always been met with healthy (and warranted) skepticism. This Court should not reach to permit a result that common sense and the law tells us is inappropriate.

III. THE STATE'S RESPONSE FAILS TO ADDRESS THE FOUR INDEPENDENTLY DISPOSITIVE GROUNDS SUPPORTING PLAINTIFFS' COMBINED MOTION.

Plaintiffs' Combined Motion presented four separate and independently sufficient grounds barring the State's standing as a matter of law. The State's Response essentially ignores three of those grounds.[6] It only addresses the fourth — that *Kerr III* precludes standing — by

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[5] It also bears emphasis that the State's brief in *Burke* supports the conclusion that fee shifting cases, such as *Schweiger v. China Doll Restaurant, Inc.*, 138 Ariz. 183, 673 P.2d 927 (App. 1983), have no relevance whatsoever to the determination of a common fund fee award.

[6]For example, the State simply begs the question as to the dispositive consequence of Mr. Killian's post-settlement admission by asserting a non-existent "settlement contract right" which, even if it had existed, is eliminated by the subsequent admission. Similarly, the State ignores other grounds of the Motions (Motions, at pgs. 2-3, and Section V of the Memorandum) that: (1) the State's participation is an ethically prohibited interference with the relationship between Class Counsel and the Class Members; (2) under no circumstances can the Attorney General simultaneously represent the Defendant and the adverse party Plaintiffs in the same litigation; and, (3) the State's attempts to diminish Class Counsel's ability to defend Class Members' interests against DOR during future settlement administration is prohibited as a denial of due process to the Class Members. The State does not dispute Class Counsel's future obligations to monitor and challenge any excessive administrative costs claimed by DOR, to represent improperly treated Class Members, and to assure DOR makes full refunds to those Class Members whose refund rights (*e.g.*, as heirs

(continued...)

misanalyzing, and even misstating, the Court of Appeals' holdings.

In lieu of responding to the substance of the Combined Motion, the State resorts to demonstrably invalid contentions that the settlement stipulation created standing by contract, or that the Court needs the State to participate as a "Friend of the Court." Ignoring the manifest impropriety of requesting the Court to appoint an *Amicus* to an ethically improper role, the State asks this Court to disregard (and even strike) the expert ethics and due process opinions of former Chief Justice Zlaket and Professor Silver. Unable to refute the experts' conclusions, the State simply proclaims innocence and launches a false *ad hominem* attack on Professor Silver in further violation of E.R. 3.3.[7]

The State's non-Response, and its admission to the Court of Appeals that Arizona law is exactly what Plaintiffs have said it is, amount to an admission Plaintiffs' Combined Motion is well founded. More importantly, the State's repeated misrepresentation to this Court of the facts and of the law underscore why the State and its attorneys have no standing to participate in the proceedings setting Class Counsel's fees. Such participation serves no permissible purpose, is ethically improper, and can only create potential due process errors which jeopardize the proposed settlement agreement with the Class.

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[6](...continued)
and ex-spouses) are derivative. Any participation by the State for the purpose of reducing Class Counsel's economic ability to defend these and other class interests deprives Class Members of their due process rights to zealous representation.

[7]The State misrepresents Professor Silver's position to this Court by selecting three brief quotes taken out of context from multiple pages of presentation and then connecting and presenting the three extracts as if it is a single paragraph, thereby falsely representing what Professor Silver actually stated. Attached as Exhibit 3 is a copy of the State's misrepresentation and the purported supporting "paragraph" (reproduced in italics) from the State's Response (at pgs. 15-16), followed by the actual text from which the State extracted, improperly assembled and misleadingly presented the three quotations. Even a cursory reading in context demonstrates, contrary to the State's misleading presentation, Professor Silver actually articulated the uncontroversial principle that constitutional requirements of due process of law for Class Members must take precedence over any state bar ethical rule which would result in a denial of such constitutional right. For most attorneys in Arizona this has been horn-book constitutional law for more than 25 years. *Bates v. State Bar of Ariz.*, 433 U.S. 350, 97 S.Ct. 2691 (1977) (ethical prohibition on attorney advertising must yield to constitutional rights).

A. THE DEPARTMENT'S RESPONSE PRESENTS A FALSE STATEMENT OF THE STANDING HOLDING IN *KERR III*.

The Department asserts that *Kerr III* holds that "[a] party's standing turns on whether it is aggrieved **by the settlement**." Department's Response at 5 (emphasis added). The Department's assertion is frivolous. In *Kerr III*, there was no settlement. If there had been a settlement, there would have been no aggrievement and no jurisdiction for an appeal. In *Kerr III*, the Department was aggrieved under the **judgment** in a contested matter, because the **judgment** required the Department to bear the costs and also pay out of its own pocket the attorneys' fees attributable to those refund claims it had disbursed without withholding the amount due for attorneys' fees. *Kerr III* holds that "a party is 'aggrieved' **by a judgment** if it denies that party some personal or property right or imposes on that party some substantial burden or obligation."*Kerr III*, 197 Ariz. at 216, 3 P.3d at 1136 (emphasis supplied).

Here, under the Settlement, the Department has bargained for and voluntarily surrendered all rights to further review or to claim aggrievement in exchange for the benefits it secured under the settlement. *See* 15A A. Jur. 2d § 24, 797 (subsequent litigation is barred by the settlement); *Phillips* v. *Musgrave,* 23 Ariz. 591, 206 P. 164 (1922) (accord). The Department cannot be aggrieved by settlement terms it has voluntarily agreed to accept in order to resolve the class' refund claims.

Moreover, there is "no substantial burden" imposed upon it **by judgment** — indeed, <u>all</u> costs for carrying out the responsibilities of the Department under the Settlement are being paid for by the Class. Also, unlike *Kerr III,* the Department readily concedes that class counsel is entitled to an award of attorneys' fees under the common fund doctrine. Thus, in all events, the issue upon which the Department claims that it is entitled to be heard in this case – the amount and manner of calculating fees to be paid by the class and not by it – does not implicate any personal or property right of the Department. Since the issue of the amount and manner of calculating fees does not deny any "personal or property right" of the Department, it is not "aggrieved," even under the Department's own illogical position. *Kerr III,* 197 Ariz. at 216, 3 P.3d at 1136.

B. IN *KERR III*, THE COURT OF APPEALS REJECTED THE DEPARTMENT'S CONTENTION THAT THE STATE HAS AN INTEREST IN PROTECTING ITS CITIZENS FROM EXCESSIVE FEES WHICH DIMINISH THE AMOUNT OF THE REFUNDS.

The Department's contention that its claim of standing is supported by decisional law from outside of Arizona is meritless. The Department made the identical argument (indeed, it cited two of the same cases) to the Court of Appeals in *Kerr III*.[8] The Court of Appeals in *Kerr III* rejected it. *See* Exhibit 3-C filed in support of Plaintiffs' Combined Motion. This line of the Department's argument further underscores the frivolousness of the Department's position here. The State's *Burke* brief establishes that the State correctly understands that, under *Kerr III,* "the defendant has no interest in the fee award." (emphasis added).

Indeed, in *Kerr III,* the Department advanced the identical argument for standing based upon the decision of the Florida Supreme Court in *Kuhnlein v. Department of Revenue,* 662 So.2d 309 (Fla. 1995), that the State of Florida had an interest in protecting its citizens from excessive fees. In repeating the very argument here that was rejected by the Court of Appeals in *Kerr III*, the Department fails to disclose to this Court the unique Florida State constitutional provision upon which *Kuhnlein* turned.

Specifically, the Department does not disclose that, unlike Arizona, the Attorney General of Florida is deemed under the Florida Constitution to exercise all common law powers, including the power of *parens patriae. See* Fla. Const. Art IV, § 4. *See also Kuhnlein,* 662 So. 2d at 311. In contrast, it is well settled in Arizona that the Attorney General is not a common law officer having the duties and powers as known in common law. *See Shute v. Frohmiller*, 53 Ariz. 483, 90 P.2d 998 (1939) *overruled on other grounds, Hudson v. Kelly*, 76 Ariz. 255, 263 P.2d 362 (1953). The position repeated here yet again by the Department is directly contrary

[8]Two of the three cases cited by the Department for its position are federal Court of Appeals cases, the most recent of which was decided over 11 years before the United States Supreme Court resolved the standing issue in *Boeing Co. v. Van Gemert*, 444 U.S. 472 (1980). The third case is a state case from Hawaii, which is contrary to the common fund law of Arizona, as reaffirmed in *Kerr III*.

to the express provisions of the Arizona Constitution. *See* Ariz. Const. Art. 5, §§ 1, 9.[9]

C. THERE IS NO CONTRACTUAL AGREEMENT GIVING THE DEPARTMENT THE STANDING THAT IT OTHERWISE LACKS UNDER ARIZONA LAW.

The Department's assertion that it somehow gained standing through the mediation process is also frivolous: there is no agreement providing the Department with standing.[10]

Contrary to the Department's false assertions, Class Counsel's attorneys' fees were not always an issue of contention in the settlement process between the Department and Class Counsel.[11] In fact, attorneys' fees only became an issue when the State raised it **eight weeks after** Class Counsel had been led to believe that a settlement in principle had been reached.

As the Department and its attorneys know, the very first written settlement proposal submitted on behalf of the Class Representative to the Department on February 13, 2002 — which became the basis for the Settlement currently before the Court — specifically addressed the subject of Class Counsel's fees in ¶ 4:

> The attorneys' fees and costs will be borne by the taxpayer class. *Attorneys' fees and costs of the taxpayer class will be determined by the Court, upon notice and opportunity of the class **(only)** to be heard on that issue.* The percentage awarded by the Court will be subtracted and paid from each of the installment refund payments when same are paid to class members.

(emphasis added.) A true and correct copy of the letter is attached hereto as Exhibit 4. The Class Representative's proposal, consistent with due process, *Kerr III* and *Boeing*, specifically provided that only the class members actually paying the fees would be entitled to challenge the request.

The Department's response to the Class Representative's proposal, sent on March 19, 2002, appeared to accept that proposal:

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[9]The repetition of this baseless argument is uniquely disturbing as part of a pattern of violations of E.R. 3.3. Why is it being presented yet again?

[10]Given the non-existence of any such purported agreement, Class Counsel does not deem it necessary to address the far-fetched proposition that parties can contractually create standing. Cf. *Thomas v. Thomas*, 203 Ariz. 34, 49 P.3d 306 (App. 2002) (parties may not create jurisdiction by consent).

[11]In this respect as well, the Department's position is based upon a knowingly made false statement of material fact. E.R. 3.3.

> **Attorneys Fees.** Attorneys for the class shall petition the Court for approval of reasonable attorney fees, taxable costs and other expenses, all of which are expenses of the class as outlined above.

(emphasis in original).

A true and correct copy of the Department's letter is attached hereto as Exhibit 5. There was no other mention of attorneys' fees in the Department's response, nor did the Department ever claim it had standing to contest the award referenced in the February 13, 2002 proposal.

With the exchange of these letters, a basis for agreement was reached and Class Counsel thereafter sent a draft settlement agreement to the Department on May 8, 2002, providing in ¶14 that only the class members could be heard on the Class Counsel's fee request. Although, the Department revised the draft agreement and returned it to Class Counsel on May 17, 2002, it did not change ¶14. In fact, it was not until the conclusion of a joint drafting session on May 17, 2002, that the Department announced, for the first time, it was asserting a "right" to be heard on Class Counsel's fee request. Prior to that date, there was no attorneys' fees dispute, and the Department's false assertion to the contrary is purely an improper attempt to prejudice the Court against Class Counsel.

Immediately upon learning that the Department intended to interfere with the fee request despite its prior agreement, Class Counsel informed the Department that such interference violated federal and Arizona law and also created numerous ethical issues given the multi-year settlement structure the Department required. Class Counsel also sent at least three letters explaining the *Kerr III* decision and the ethical rules that precluded the Department's interference. True and correct copies of these letters are attached hereto as Exhibit 6. The Department's only response was sent on June 5, 2002, in which the Department, citing *Kerr III*'s ruling **on aggrievement**, claimed a right to be heard, while ignoring the Court of Appeals' adverse ruling **on standing**. *See* Exhibit 7 hereto.

Following consultation with its ethics advisers, Thomas Zlaket and Professor Silver, Class Counsel informed the Department it could not ethically enter into a multi-year settlement that allowed the Department to control or appear to control Class Counsel's continuing future representation of its clients through the Department's retention of the power to appeal, and

thereby prevent payment of, Class Counsel's fees. As a result, the parties were at an impasse.

The parties thereafter engaged in mediation before the Hon. Bruce Meyerson (Ret.) to resolve this and their other remaining disputes.[12] The mediation left the question of the Department's standing, which remained hotly contested, for this Court to decide. After Mr. Meyerson arrived at his recommended range, which both sides accepted, the appellate risk impasse to the settlement was resolved. The Department's counsel revised the draft settlement agreement to incorporate the results of the mediation, and Paragraph 14 of the final agreement, which the Attorney General drafted, unambiguously provides that the issue of the Department's standing to argue within the range was unresolved and remained for this Court to resolve:

> **14. ATTORNEYS' FEES AND COSTS.** Class Counsel and the Department agree that class counsel are entitled to reasonable attorneys' fees for their efforts in this matter. There is a dispute, however, as to the amount of fees that may be considered reasonable. **Further, Class Counsel contends that the State does not have standing to contest the amount of attorneys' fees and costs awarded by the court because they are being paid from the common fund.** The State contends that it does have standing to be heard on the issue of fees and costs. To avoid further delay in the settlement process, the Department and Class counsel agreed to a process of mediation whereby a neutral expert was used to make a recommendation after having been briefed by both sides. . . Class counsel and the Department shall be free to argue to the court for any determination of an attorneys' fee within the range recommended by the neutral expert. **Further, this agreement does not resolve the legal issue of whether the State Defendants have standing to contest any request by Class Counsel for Attorneys' Fees and Costs.. . .**
>
> Class Counsel shall file a Motion with the Court for its claims for Attorneys' Fees and Costs in an amount not to exceed twelve percent (12%) times the lessor of the Common Fund or the Cap. **The class members shall be provided with notice, through the Notice of Class Certification, of the amount requested by Class Counsel for Attorneys' Fees and Costs and shall be provided with an opportunity to be heard.** ***The Court may determine the standing of anyone else to be heard concerning Class Counsel's motion.***

(emphasis added).

As can be readily seen, the Department has no contractual right to standing under the very agreement it drafted, which contains the parties' entire agreement on this subject. (Paragraph 23 of the agreement, entitled "Modification; Integration," expressly provides that "the Stipulation contains the parties' entire agreement with respect to the subject matter of this action.")

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[12] As reflected in Exhibit 8 hereto, several other disputed issues had also arisen as the result of the Department's subsequent unilateral revision of the settlement document which had been prepared at the conclusion of the May 17, 2002 joint drafting session.

Because there is no basis affording the Department standing, the Department (and its attorneys) remain, at best, officious intermeddlers who must not participate at the fee hearing.

D. THERE IS NO BASIS UPON WHICH THE STATE MAY BE ALLOWED TO PARTICIPATE IN THE FEE HEARING AS AN *AMICUS*. IT HAS NOTHING TO OFFER, AND ITS PRESENCE WOULD VIOLATE THE CLASS MEMBERS' RIGHTS TO DUE PROCESS.

In its final desperate gasp, the Sate contends it should be permitted to participate as an *Amicus Curiae*. First, an *Amicus* has a role, if at all, only in appellate proceedings. ARIZ. R. CIV. APP. P. 16. An *Amicus* cannot participate in a trial court evidentiary proceeding or conduct discovery. Second, neither of the cases the State cites supports its alternative *Amicus* request which, as Mr. Zlaket explains, would be improper.

As discussed above, *WPPSSS* recognizes that the State has no interest whatsoever in this issue. The second case pin cited by the State in support of its *Amicus* request is "*City of Detroit v. Grinnell Corp.*, 560 F.2d 1093, 1098 (2nd Cir. 1977)." This case is likewise unpersuasive. More than two years ago, the Second Circuit overruled *Grinnell's* holding that fees in common fund cases must be determined under the lodestar method and recognized that the percentage method is an appropriate method. *See Goldberger v. Integrated Resources, Inc.*, 209 F.3d 43, 49 (2nd Cir. 2000) ("[W]e see no need to compel district courts to undertake the 'cumbersome, enervating, and often surrealistic process' of lodestar computation.") (citations omitted).

The State contends its *Amicus* request is based on a desire to protect the integrity of the judiciary and the legal profession. It also claims it has information not readily available to anyone else. In light of its demonstrated lack of candor here, the State's claims can most charitably be labeled *chutzpah*. The State's overreaching merely underscores its desire to discourage any other lawyer from ever attempting again what Class Counsel achieved here for the benefit of the taxpayers of Arizona — taxpayers who otherwise could not have afforded counsel to vindicate the important constitutional rights successfully enforced in this case.

As to the State's purported desire to protect the integrity of the judiciary and the legal profession, Thomas Zlaket's expert opinion demonstrates there is no basis upon which the State's counsel may ethically be allowed to participate in the fee hearing in <u>any capacity</u>.

Professor Silver's expert opinion establishes that it would also be a violation of due process to permit the State to participate in the fee hearing. And if that were not enough, the State's conduct on this Motion has irrefutably demonstrated that unless stopped by this Court, it is the State who will undermine the integrity of the judiciary and the legal profession.

The fact of the matter is, as in every common fund case, this Court possess the skill, experience and integrity to discharge the judicial function of determining a fair and reasonable fee, taking into account all of the relevant factors that courts consider in making such awards. In addition, the Court has the independent recommendation of Mr. Meyerson. Finally, as counsel for the State has so ably demonstrated to the Arizona Court of Appeals in *Burke*, the Court's determination with respect to Class Counsel's fees is of "**no concern whatsoever**" to the State and there is no legitimate basis for it to appear as an *Amicus*.

As to the State's claim to possess special information, the truth is that all information relevant to this case now is of public record. The State has no information that is not readily available to anyone else. Indeed, even the State's unseemly efforts to settle this case in September 2001 by buying off Class Counsel were disclosed to the Arizona Supreme Court by Class Counsel in its filings. And, it is certain that the Department will not highlight for this Court the dramatic shift in its position on attorneys' fees in this case from then until now: When it sought to have Class Counsel settle the case in September 2001 for a fraction of the current recovery, it indicated to Class Counsel that a substantial percentage fee in the 20% range was no problem. However, when it became clear that Class Counsel would not sell out the class and, further, would insist on settlement terms that were judicially enforceable in order to protect the class, the Department embarked on its current course in its unsuccessful effort, to date, to compromise Class Counsel's independence.

The State's improper motive for wanting to appear is underscored by its repeated intentional misstatements of fact. Such misstatements are not the purpose of an *Amicus*. For example, the Department's efforts to distort this process by suggesting estimates of wildly exaggerated hourly rates are based on contentions that the Department knows are false. First, the common fund is capped at $350 million, it is not established at that level. Already, there

have been many hundreds of opt-outs, which reduces the recovery below $350 million. Thus, contrary to the Department's contention, there is no certainty that $350 million will be paid out. Second, prior Department practice demonstrates that even in cases involving perfect taxpayer information there is a substantial rate of meritorious taxpayer challenges to the Department's refund determinations. *See* Exhibit 9 attached hereto. In this case, there are over 600,000 class members and imperfect records. Based on prior history, Class Counsel will be required to provide an extraordinary amount of future services to insure the recovery for the class is maximized.

Third, based on the experience of one of the leading class action administration firms, even with no problems in settlement administration, the Department knows that Class Counsel will spend approximately $800,000 just to maintain a national call center of trained paralegals who are working under the direct supervision of Class Counsel.[13] Based upon actual experience in maintaining such call centers in other comparable cases, it is estimated that Class Counsel's call center will process well over 200,000 calls during the next four years and well over 30,000 of those calls will require follow up by Class Counsel. To date, even before final settlement approval, Class Counsel has handled thousands of written and telephonic inquiries from Class Members.

Finally, although the settlement contains penalties if the State fails to perform, politicians may attempt to interfere with the State's performance. For example, in the November 21 and 22, 2002 Arizona Republic, articles report a current dispute between politicians who want to take money earmarked for the settlement in this case and use it to reduce the current budget deficit and the November 21, 2002 Editorial recommends considering such diversion. See Exhibit 10 attached hereto. If this were to happen during the 4-year refund period, Class Counsel will be required to enforce the settlement.

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[13]This $800,000 expense includes only the facility cost of operating the call center and does not take into account Class Counsel's other expenses and time to respond to class member inquiries and for experts to evaluate the Department's performance to restore records and pay the refunds due.

IV. THE DEPARTMENT HAS ALREADY FAILED TO RESPOND TO CLASS ADMINISTRATION ISSUES THEREBY UNDERSCORING THE SOUNDNESS OF THE EXPERT OPINIONS THAT THE DEPARTMENT HAS NO INTEREST IN PROTECTING THE CLASS.

Since the date of this Court's order preliminarily approving the settlement, Class Counsel's efforts have been devoted to responding timely to class members' inquiries so that they all may participate in the refund recovery. From the inception of that effort, it has been clear that there are two significant segments of the class — divorced taxpayers and heirs of deceased taxpayers — who require Departmental guidance as to the documentary evidence the Department will need to demonstrate entitlement to a refund. Class Counsel has repeatedly sought input on this issue from the Department. *See* Exhibit 11 hereto. Yet, Class Counsel has received no response.[14]

Certainly, if the Department and its attorneys were truly concerned with maximizing the recovery of class members, an immediate response would have been provided. The settlement has not yet been finally approved and we, as Class Counsel, are already concerned that if it is this difficult now to obtain a simple response to a straightforward request, what are the next four years going to be like, particularly for those class members whose records the Department failed to preserve or whose records prove to be so degraded they cannot be restored?

Similarly, the Department's failure to respond timely with guidance will directly result in inefficiencies in the administration of the settlement. This, in turn, adversely affects all class members because every dollar the Department wastes in this process is a dollar that could be returned to the class. For example, in the absence of guidance, counsel for estates and trusts have been making protective filings with the Department, which (depending upon the ultimate guidance of the Department) may prove to have been unnecessarily detailed and costly or may have to be redone because deemed deficient in either form or content by the Department. And, if they have to be redone, experience in the administration of class action settlements establishes that in many cases class members will be discouraged and believe it is not worth the effort to

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[14]Indeed, Director Killian acknowledged in his KAET interview the significant burdens presented by the extraordinary divorce and death rates in this class. *See* Exhibits C4 and C5 filed in Support of Plaintiff's Combined Motion.

redo it. But, in all events, there will have been significant and unnecessary processing costs. This fact underscores the soundness of both expert opinions submitted by Class Counsel that there is no legitimate basis for the State to be heard here. **It only cares about the members of the class when Class Counsel forces it to care.**

V. CONCLUSION.

No one – not even the State – is above the law. Here, the State has knowingly misstated the law and the facts, not to mention engaged in vexatious motion practice in direct violation of settled preclusion principles. In view of this record, this Court must grant Plaintiffs' Combined Motion to protect the integrity of the judiciary and the legal profession.

Dated this 22nd day of November, 2002.

BONN & WILKINS CHARTERED
O'NEIL, CANNON & HOLLMAN, S.C.

By: _____
Paul V. Bonn, Esq.
Randall D. Wilkins, Esq.
Eugene O. Duffy, Esq.
D. Michael Hall, Esq.
Attorneys for Plaintiffs

ORIGINAL filed and a copy hand-delivered this 22nd day of November, 2002, to:

The Honorable Paul A. Katz
Maricopa County Superior Court
125 West Washington
Phoenix, Arizona 85003

COPY of the foregoing hand-delivered this 22nd day of November, 2002, to:

Michael F. Kempner
Chief Counsel, Tax Section
Office of the Attorney General
1275 West Washington
Phoenix, Arizona 85007

_____

Department's Motion to Set Deadline to Substantiate Attorneys Fee Request:

The party petitioning for attorneys' fees has the burden of submitted sufficient documentation, including detailed time records, to justify the fees requested. *In re Washington Pub. Power Supply Sys. Sec. Litig.*, 19 F.3d 1291, 1305 (9th Cir. 1994) ("*WPPSSS*"). In Arizona, courts may deny deficient fee applications. *See Schweiger v. China Doll Restaurant, Inc.*, 138 Ariz. 183, 189, 673 P.2d 927, 933 (App. 1983).

* * *

Further, this court would need the Department's input into the reasonableness of the time expended by class counsel as it is the Department and their counsel who would have insight into the reasonableness of time expended over the last twelve years.

* * *

The Arizona Court of Appeals provided specific guidance in how to calculate a reasonable fee in its preeminent decision *Schweiger v. China Doll Restaurant, Inc.*, 138 Ariz. 183, 673 P.2d 927 (App. 1983).

* * *

Generally, courts start their analysis of a reasonable fee with the number of hours reasonably expended on the litigation multiplied by a reasonable hourly rate. *Hensley v. Eckerhart*, 461 U.S. 424, 434 (1983). This analysis is commonly referred to as the "lodestar" amount.

* * *

Because neither the Court nor the class members were involved in much of the litigation, the Department is actually in the best position to comment on the reasonableness of Class Counsel's time.

[Motion to Set Deadline, etc., pg. 2, line 26-pg. 3, line 4; pg. 2, lines 13-16; pg. 4, lines 17-19; pg. 4, lines 23-26; pg. 8, lines 11-13.]

The State's Response Memorandum:

In addition, class counsel wants this court to ignore *Schweiger v. China Doll Restaurant, Inc.*, [citation omitted], *Viscaino* and *WPPSSS* and E.R. 1.5, all of which discuss the consideration of time and labor in determining reasonable attorneys fees. [pg. 14, lines 1-4].

* * *

The Department set forth [in its Motion to Set Deadline, etc.] the significant body of law supporting the use of time records as either the primary basis for fee awards, or alternatively as a cross-check on the reasonableness of a percentage fee award. [pg. 15, footnote 4]

ARIZONA COURT OF APPEALS

DIVISION TWO

JAMES J. BURKE,

Plaintiff-Appellee,

v.

ARIZONA STATE RETIREMENT SYSTEM, an Agency of the State of Arizona; the STATE OF ARIZONA; and the ARIZONA BOARD OF REGENTS, an Agency of the State of Arizona,

Defendants-Appellants.

2 CA–CV 02-0035

PIMA COUNTY
SUPERIOR COURT
NO. CV–316479

DEFENDANTS-APPELLANTS' OPENING BRIEF

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TABLE OF CONTENTS

TABLE OF CITATIONS

CASES

STATUTES

RULES

OTHER AUTHORITIES

The court, double-checking the award against the lodestar method, determined that $2,600 per hour was too much. [*Id.*] It therefore halved the award to $3,708,446.50.[8] [*Id.*]

This order effectively awarded Counsel $1,314.35 for each hour they said they worked on the case.

The court signed the minute entry, which was filed on December 17, 2001. [*See id.*] On January 15, 2002, the Defendants filed a timely Notice of Appeal. [R.A. 246.][9] This Court has jurisdiction under either A.R.S. § 12-2101(B) or (C).

ISSUES PRESENTED FOR REVIEW

1. The common-fund doctrine spreads attorneys' fees among the class of persons who benefit from an attorney's labors. It does not apply in a statutory fee-shifting case, where the defendants do not benefit from the attorneys' services but must pay the fees. The superior court here ordered the Defendants to pay the

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[8]. This amount again included Class Counsel's costs.

[9]. Class Counsel had submitted a formal judgment [*see* R.A. 241], which the Court signed and entered on January 17, 2002 [R.A. 248]. To ensure that there was no question about their intent, the Defendants filed a Supplemental Notice of Appeal on January 30 from both the signed December minute entry order and the formal January judgment. [R.A. 252.]

Some school districts had intervened as Defendants. [R.A. 179–82.] They have not appealed the court's ruling against them.

Plaintiffs' attorneys. Did it err in applying the common-fund doctrine in calculating the amount of that award?

2. Even if the court had discretion to calculate the fees as a percentage of the fund, it still had to make a reasonable award. Did it abuse its discretion in awarding a rate of over $1,300 per hour?

SUMMARY OF ARGUMENT

The trial court's analysis of the attorneys' fees issue was fundamentally flawed. It shifted the fees to the Defendants, but it ordered them to pay the fees under a fee-sharing doctrine.

Fee shifting and fee sharing are quite different. The latter applies when a plaintiff pursues litigation that creates or protects a fund from which many other parties benefit. Under the common-fund doctrine, the court may compensate the plaintiff for the attorneys' fees incurred in creating or protecting that fund by ordering the benefiting parties to share in the legal expenses. It accomplishes this by compensating the plaintiff's attorney *from the very fund created or protected by those labors*.

Here, by contrast, the court awarded fees *against the Defendant*, not against the fund. Its order does not serve to spread the fees among those who benefit from Class Counsel's actions. The court therefore erred by applying the common-fund doctrine.

B. The Common-Fund Doctrine Spreads Attorneys' Fees Among the Plaintiff Class, the Beneficiaries of the Litigation; It Does Not Apply to Shift Fees to Defendants, Who Do Not Benefit from the Litigation.

The superior court should not have applied the common-fund doctrine in awarding attorneys' fees against the Defendants because an award against them does not serve the purpose of that doctrine. It is designed to spread fees among the class of persons who benefit from the litigation so they will not be unjustly enriched at the plaintiff's expense. Shifting the fees to a third party—here, the Defendants—does not accomplish that purpose.

1. The Common-Fund Doctrine Is an Equitable Exception to the American Rule.

Under the traditional American Rule, each party bears its own attorney's fees, regardless of who prevails. *E.g.*, *Marcus v. Fox*, 150 Ariz. 333, 334, 723 P.2d 682, 683 (1986); *Schwab Sales, Inc. v. GN Constr. Co.*, 196 Ariz. 33, 35, 992 P.2d 1128, 1130 (App. 1998). The American Rule prevails unless a statute or an applicable legal or equitable allows the court to adjust fees. *See, e.g.*, A.R.S. § 12-341.01(A); 42 U.S.C. § 1988; *Marcus*, 150 Ariz. at 334, 723 P.2d at 683; *Schwab Sales*, 196 Ariz. at 35, 992 P.2d at 1130; *Alyeska Pipeline Serv. Co. v. Wilderness Soc'y*, 421 U.S. 240, 245, 95 S.Ct. 1612, 1615 (1975).

The common-fund is an equitable doctrine that allows the court to spread the fees among the discrete group of persons who share in the benefits of the actions of the plaintiff's attorney. *E.g.*, *Kerr v. Killian*, 197 Ariz. 213, 217–18, ¶ 19, 3 P.3d 1133, 1137–38 (App. 2000); *LaBombard v. Samaritan Health Sys.*, 195 Ariz. 543, 550, 991 P.2d 246, 253 (App. 1998); *Bebchick v. Washington Metro. Area Transit Comm'n*, 805 F.2d 396, 402 (D.C. Cir. 1986); *B.P. North America Trading, Inc. v. Vessel Panamax Nova*, 784 F.2d 975, 977 (9th Cir. 1986).

2. The Main Rationale of the Common-Fund Doctrine Is to Avoid Unjust Enrichment.

The courts generally cite restitution and the desire to avoid unjust enrichment as the rationale for applying the common-fund doctrine to spread fees among the beneficiary class. If the plaintiff incurs attorneys' fees pursuing litigation to create or preserve a fund that benefits others, those who reap the benefit are unjustly enriched if they do not have to pay some of the fees. *E.g.*, *Kerr*, 197 Ariz. at 218, ¶ 19, 3 P.3d at 1138; *LaBombard*, 195 Ariz. 549–50 ¶ 25, 991 P.2d 252–53; *Boeing Co. v. Van Gemert*, 444 U.S. 472, 478, 100 S.Ct. 745, 749 (1980); *In re Coordinated Pretrial Proceedings in Petroleum Prods. Antitrust Litig.*, 109 F.3d 602, 608 (9th Cir. 1997); *Thirteen Appeals*, 56 F.3d at 305 n.6; *Gottlieb v. Barry*, 43 F.3d 474, 482 (10th Cir. 1994); *Democratic Cent. Comm. of Dist. of Columbia v. Washington*

Metro. Area Transit Comm'n, 3 F.3d 1568, 1573 (D.C. Cir. 1993); *Swedish Hosp. Corp. v. Shalala*, 1 F.3d 1261, 1265 (D.C. Cir. 1993); *Paul, Johnson, Alston & Hunt v. Graulty*, 886 F.2d 268, 271 (9th Cir. 1989); *Jordan v. Heckler*, 744 F.2d 1397, 1400–01 (10th Cir. 1984).[10]

3. Under the Common-Fund Doctrine the Attorneys' Fees Come From the Fund; They Are Not Taxed Against the Defendant.

In accord with its purpose, under the common-fund doctrine the attorneys' fees come from the fund that the attorneys' efforts created or preserved, and thus are borne by those who benefit. *E.g.*, *Hobson v. Mid-Century Ins. Co.*, 199 Ariz. 525, 530, 19 P.3d 1241, 1246 (App. 2001); *LaBombard*, 195 Ariz. at 548, ¶ 22, 991 P.2d at 251; *In re Estate of Brown*, 137 Ariz. 309, 312, 670 P.2d 414, 417 (App. 1983); *Boeing Co.*, 444 U.S. at 478, 100 S.Ct. at 749 ("a fee awarded against the entire judgment fund will shift the costs of litigation to each absentee in the exact proportion that the value of his claim bears to the total recovery"); *Alyeska Pipeline*, 421 U.S. at 257, 95 S.Ct. at 1621; *Thirteen Appeals*, 56 F.3d at 305; *Democratic Cent. Comm.*, 3 F.3d at

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[10] Another rationale is that the plaintiff, as representative of the class, "is authorized to contract for the entire class and is therefore authorized to pay the expense of litigation with funds intended to benefit the entire class." *Democratic Cent. Comm.*, 3 F.3d at 1573. And, "[c]ommon fund fees derive in part from the common law premise that a trustee is entitled to reimbursement from the fund administered." *Brown v. Phillips Petroleum Co.*, 838 F.2d 451, 453–54 (10th Cir. 1988).

1572; *Cook v. Niedert*, 142 F.3d 1004, 1011 (7th Cir. 1998) ("In common fund cases, after attorneys obtain a settlement for the class, they petition the court for compensation from the fund that has been established for the benefit of the plaintiffs"); *Knight v. United States*, 982 F.2d 1573, 1579–80 (Fed. Cir. 1993); *Paul, Johnson*, 886 F.2d at 271 (the doctrine properly only applies if "(1) the class of beneficiaries is sufficiently identifiable, (2) the benefits can be accurately traced, and (3) the fee can be shifted with some exactitude to those benefiting.")

Thus, the common-fund doctrine is a fee-*sharing* rule: it allows the court to ensure that the parties who benefit from the plaintiff's work will share in his fees. *LaBombard*, 195 Ariz. at 550, ¶ 28, 991 P.2d at 253 (quoting *Trevino v. HHL Fin. Servs., Inc.*, 945 P.2d 1345, 1347 (Colo. 1997)); *Bebchick*, 805 F.2d at 402; *B.P. North America*, 784 F.2d at 977.

4. Fee-Shifting—Awarding Fees Against the Other Party—Is Incompatible with the Common-Fund Doctrine.

The fact that an award of fees under the common-fund doctrine comes from the fund—and thus is borne by the beneficiary class—distinguishes it from awards made against the opposing party. Fee-sharing under the common-fund doctrine is not the same as fee-shifting, under which the opposing party must pay its opponent's attorneys' fees. *Kerr*, 197 Ariz. at 217–18 ¶¶ 16 & 19, 3 P.3d at 1138.

The Tenth Circuit has clearly distinguished fee-sharing from fee-shifting:

> The award of attorneys' fees is based on substantially different underlying purposes in a common fund case than in a statutory fees case. The common fund doctrine "rests on the perception that persons who obtain the benefit of a lawsuit without contributing to its costs are unjustly enriched at the successful litigant's expense." ... Fees in common fund cases are extracted from the predetermined damage recovery rather than obtained from the losing party. Thus, common fund fees are neither intrinsically punitive nor designed to further any statutory public policy. Conversely, statutory fees are intended to further a legislative purpose by punishing the nonprevailing party and encouraging private parties to enforce substantive statutory rights. Thus, unlike statutory fees, which result in a *shifting* of the fee burden to the losing party, common fund fees result in a *sharing* of the fees among those benefited by the litigation.

Brown v. Phillips Petroleum, 838 F.2d at 453–54 (punctuation and citations omitted).

In common-fund-doctrine cases, "the payment of attorney's fees ultimately reduces the amount of the common fund." *Cook*, 142 F.3d at 1011. It is by this mechanism that the fees are apportioned among the benefiting class in exact proportion to each member's interest in the fund recovered. *Boeing Co.*, 444 U.S. at 478, 100 S.Ct. at 749; *Paul, Johnson*, 886 F.2d at 271; *B.P. North America*, 784 F.2d at 977. By contrast, awarding fees against the defendant does not operate to spread the fees among the beneficiaries who share in the benefits of the plaintiff's attorneys' labors; it shifts them to a completely different party. *Jordan*, 744 F.2d at 1400.

5. Unlike Fee-Shifting, Fee-Sharing Causes a Change in the Relationship Between Attorney and Client.

Further demonstrating the difference between common-fund cases and fee-shifting cases under statutory provisions is the changing relationships among the participants. Under the common-fund doctrine, the court makes its award against the fund, thereby reducing the amount the class beneficiaries ultimately receive. This changes the nature of the attorneys' relationship: at that point they become adversaries of the plaintiff class: "Because the payment of attorney's fees ultimately reduces the amount of the common fund, after attorneys secure a settlement, their role changes from one of a fiduciary for the clients to that of a claimant against the fund created for the clients' benefit." *Cook v. Niedert*, 142 F.3d at 1011–12 (punctuation and citation omitted); *accord In re Washington Pub. Power Supply Sys. Sec. Litig.*, ("*WPPSS*") 19 F.3d 1291, 1302 (9th Cir. 1994); *Democratic Cent. Comm.*, 3 F.3d at 1573; *Swedish Hosp.*, 1 F.3d at 1265.

Because a fee award under the common-fund doctrine spreads the fees to the beneficiary class, not the defendant, the defendant has nc interest in the fee award. *Boeing Co.*, 444 U.S. at 481–82, 100 S.Ct. at 751; *Petroleum Prods. Antitrust Litig.*, 109 F.3d at 608; *Brown v. Phillips Petroleum*, 838 F.2d at 456; Report of the Third Circuit Task Force, *Court Awarded Attorney Fees*, 108 F.R.D. 237, 251 (1985);

Knight, 982 F.2d at 1579; *Kerr*, 197 Ariz. at 217, ¶ 16, 3 P.3d at 1137. The District of Columbia Circuit has noted the contrast:

> The opposing party in the common fund case, unlike the loser in a fee-shifting case, stands to lose no more if the attorneys' fee award is greater and therefore cannot be relied upon to provide an adversarial approach to deleting unreasonable time entries.

Swedish Hosp., 1 F.3d at 1268–69.

That is not true here. Because the award was made against the Defendants—not the fund and, by extension, the Plaintiff Class—it is the Defendants who are before this Court fighting to reduce the award to a reasonable amount.

6. The Common-Fund Doctrine Allows Fees Against the Defendant Only If It Would Further the Doctrine's Purpose.

There are only very limited circumstances where it is appropriate to apply the common-fund doctrine against the defendant. The only time it makes sense is when doing so will actually spread the fees among those who will benefit, that is, when the defendant is itself the beneficiary group or that group's representative. Examples include a shareholder's suit against a corporation that benefits all the shareholders or a union member's suit against a union that benefits all the members. *See, e.g.,*, *Hall v. Cole*, 412 U.S. 1, 8, 93 S.Ct. 1943, 1947 (1973) ("reimbursement of respondent's attorneys' fees out of the union treasury simply shifts the costs of litigation to 'the class that has benefited from them and that would have had to pay them had it

brought the suit'" (footnote omitted)); *Mills v. Elec. Auto-Lite Co.*, 396 U.S. 375, 397, 90 S.Ct. 616, 627 (1970) ("reimbursement of the plaintiffs' attorneys' fees out of the corporate treasury simply shifted the costs of litigation to 'the class that has benefited from them and that would have had to pay them had it brought the suit.'"); *Southerland v. Int'l Longshoremen's & Warehousemen's Union, Local 8*, 845 F.2d 796, 798 (9th Cir. 1987) ("Reimbursement of a plaintiff's costs and attorneys' fees 'shifts the costs of litigation to 'the class that has benefited from them and that would have had to pay them had it brought the suit'").

When there is no such relationship between the defendant and the beneficiary class, fees are not appropriately awarded under this rationale:

> To justify an award of fees under either of these exceptions, the target of the award must, at minimum, stand "in such a relationship to the benefited class that the award will 'operate to spread the costs proportionately' and 'with some exactitude' among identifiable beneficiaries of the fee-seeker's success." ... Without this sharing of costs among third party beneficiaries, an award against Way Wiser is simply an award against an opposing party, and as such is forbidden by the general admiralty rule.

B.P. North America, 784 F.2d at 977 (citations omitted).

C. The Trial Court's Award Shifted the Fees to the Defendants; It Did Not Apportion Them Among the Beneficiary Class.

Awarding fees against the defendant does not spread the fees among the beneficiaries who share in the benefits of the plaintiff's attorneys' labors:

> "Application of the "common benefit" exception which spreads the cost of litigation to those persons benefiting from it would "stretch it totally outside its basic rationale ... ." "[I]mposing attorneys' fees on Alyeska will not operate to spread the costs of litigation proportionately among these beneficiaries ... ."

Alyeska Pipeline, 421 U.S. at 245 and n.14, 95 S.Ct. at 1616 and n.14 (quoting *Wilderness Soc'y v. Morton*, 495 F.2d 1026, 1029, 1037-1038 (D.C. Cir. 1974)). Indeed, even the Third Circuit Task Force on attorneys' fees, with class counsel's expert witness, Professor Arthur Miller, as its reporter, recognized the distinction: "As the Task Force Report explains, a key element of the common fund case is that fees are not assessed against the unsuccessful litigant (fee shifting), but rather, are taken from the fund or damage recovery (fee spreading)." *Camden I Condominium Ass'n v. Dunkle*, 946 F.2d 768, 774 (11th Cir. 1991) (citing *Court Awarded Attorney Fees,* Report of the Third Circuit Task Force (Arthur R. Miller, Reporter), 108 F.R.D. 237, 250 (Oct. 8, 1985); *accord Thirteen Appeals*, 56 F.3d at 306; *Swedish Hosp.*, 1 F.3d at 1266–67; *Brown v. Phillips Petroleum*, 838 F.2d at 454. The Ninth Circuit agrees: "Although the common fund doctrine does not permit the *shifting* of the burden of the litigation expenses to the losing party, it does permit the burden to be *shared* among those who are benefited by the litigant's efforts." *Paul, Johnson*, 886 F.2d at 271 (emphasis in original, citations omitted).

When awarding fees under A.R.S. § 12-341.01(A), this Court begins with the lodestar amount. *See Sanborn v. Brooker & Wake Prop. Mgmt., Inc.*, 178 Ariz. 425, 431, 874 P.2d 982, 988 (App. 1994). "The most useful starting point for determining the amount of a reasonable fee is the number of hours reasonably expended on the litigation multiplied by a reasonable hourly rate." *Id.* at 430, 874 P.2d at 989 (quoting *Timmons v. City of Tucson*, 171 Ariz. 350, 357, 830 P.2d 871, 878 (App. 1991), quoting, in turn, *Hensley v. Eckerhart*, 461 U.S. 424, 433, 103 S.Ct. 1933, 1939 (1983)); *accord State ex rel. Corbin v. Tocco*, 173 Ariz. 587, 591, 845 P.2d 513, 517 (App. 1992) (the general rule for calculating attorneys fees made pursuant to a statute authorizing the recovery of reasonable fees is the lodestar calculation).

The lodestar figure is the "guiding light" of fee-shifting jurisprudence, and the United States Supreme Court has established a strong presumption that the lodestar represents the reasonable fee. *City of Burlington v. Dague*, 505 U.S. 557, 562, 112 S.Ct. 2638, 2641 (1992). The federal courts consistently use the lodestar to determine the fee in statutory attorneys' fees cases:

> In statutory fee cases "the most useful starting point for determining the amount of a reasonable fee is the number of hours reasonably expended on the litigation multiplied by a reasonable hourly rate." *Hensley v. Eckerhart*, 461 U.S. 424, 434, 103 S.Ct. 1933 (1983). This formulation, generally known as the lodestar method, provides the starting point for appellate court review of statutory fee awards to determine whether a trial court has abused its discretion.

Although it is evident that the award was made under A.R.S. § 12-341.01(A) because this case arises out of contract, even if the court awarded fees under some other authority, the lodestar was the correct method for determining those fees. That is true because the court *shifted* the fees to the Defendants. Thus, had the court relied on some authority other than the fee statute, it still should have applied the lodestar. *See, e.g., Kadish v. Ariz. State Land Dep't*, 177 Ariz. 322, 331–32, 868 P.2d 335, 344–45 (App. 1993) (lodestar applied to determine fee awarded against government defendant under private-attorney-general doctrine); *accord Tocco*, 173 Ariz. at 592, 845 P.2d at 518.

The overriding fact, one that cannot be evaded, is that this is a fee-shifting case, not a fee-sharing one. The lodestar is therefore the correct method, and the superior court erred by not using it.

E. The Only Contrary Authorities That Class Counsel Presented Are Inapplicable Because They Dealt With an Entirely Different Situation.

In the face of all this authority clearly showing that the common-fund doctrine was inappropriate here, Class Counsel presented only two cases in support of their contrary contention, *Johnston v. Comerica Mortgage Corp.*, 83 F.3d 241 (8th Cir. 1996), and *In re General Motors Corp. Pick-Up Truck Fuel Tank Prods. Liab. Litig.*,

In granting the Defendants' Motion for New Trial and cutting its original award in half, the superior court stated that it had checked its award against the lodestar method. Halving the original $7.4 million award was a step in the right direction, but it did not come close to fully accomplishing the task. The $3.7 million award still gave Class Counsel over $1,300 for each hour they attested they worked on the case. That is not a reasonable sum to have awarded against the Defendants.

C. Strong Policy Reasons Support Using the Lodestar Rather Than the POF Method in Statutory Fee-Shifting Cases.

Choosing whether to apply the lodestar or POF is much more than just a matter of form. There are compelling economic and policy reasons for not applying the same methodology for determining the amount of a fee-shifting award as for determining the amount of a fee-sharing award:

> In *Dague*, the Court held that the private market's model of paying premiums for the risk of non-payment was inapplicable in statutory fee-shifting cases. For a variety of reasons, the Court concluded that the private market practice of rewarding attorneys for taking cases on a contingency basis would unduly burden losing parties who are required by statute to pay no more than a "reasonable" fee for the services rendered by the winning party's attorneys in that particular case. *Dague*, 505 U.S. at 562–63 112 S.Ct. at 2641. For example, the Court reasoned that it would be incompatible with fee-shifting statutes to burden losing parties with a contingency enhancement that has the effect of compensating the winning attorneys for time gambled away in the contingency cases they lose:
>
> An attorney operating on a contingency-fee basis pools the

> risks presented by his various cases: cases that turn out to be successful pay for the time he gambled on those that did not. To award a contingency enhancement under a fee-shifting statute would in effect pay for the attorney's time (or anticipated time) in cases where his client does *not* prevail.

Id. at 565, 112 S.Ct. at 2643 (emphasis in original). This concern, along with concern over the complexity and cost of administering a system of contingency enhancements in the statutory fee context, drove the Court to the conclusion that "[i]t is neither necessary nor even possible for application of the fee-shifting statutes to mimic the intricacies of the fee-paying market in every respect." *Id.*

WPPSS, 19 F.3d at 1300 (footnote omitted). The same concerns do not necessarily apply in a true common-fund doctrine case:

> There is nothing unfair about contingency enhancements in common fund cases because of the equitable notion that those who benefit from the creation of the fund should share the wealth with the lawyers whose skill and effort helped create it. [I]n the common fund context, attorneys whose compensation depends on their winning the case, must make up in compensation in the cases they win for the lack of compensation in the cases they lose.
>
> Thus, the concerns expressed in *Dague* about unduly burdening losing parties in statutory fee cases are not present in common fund cases where fees are paid out of the settlement fund. How the fund is divided between members of the class and class counsel is of no concern whatsoever to the defendants who contributed to the fund. In a common fund case, where there is no direct or immediate danger of unduly burdening the defendant, a court has more latitude in exercising its equitable powers to determine whether the plaintiff class should compensate its attorneys for their risk of nonpayment. ... [W]e find *Dague*'s reasoning inapposite in the common fund context ...

WPPSS at 1300–01 (9th Cir. 1994) (punctuation, citations and footnote omitted).

In addition, the superior court's use of the POF method here thwarts the policy of encouraging settlement. The award—if affirmed—would be a strong *dis*incentive to settle similar cases arising in the future.

"It has always been the policy of the law to favor compromise and settlement; and it is especially important to sustain that principle in this age of voluminous litigation ... ." *Dansby v. Buck*, 92 Ariz. 1, 11, 373 P.2d 1, 8 (1962); *Emmons v. Superior Court*, 192 Ariz. 509, 512 ¶ 11, 968 P.2d 582, 585 (App. 1998); *accord Phillips v. Musgrave*, 23 Ariz. 591, 594-95, 206 P. 164, 165 (1922); *Myers v. Wood*, 174 Ariz. 434, 435, 850 P.2d 672, 673 (App. 1992) ("sound legal policy ought to favor compromise and settlement over litigation"). As our Supreme Court said many years ago: "Courts look with favor upon stipulations designed to simplify and settle litigation and save cost to the parties ... ." *Crunden-Martin Mfg. Co. v. Christy*, 22 Ariz. 254, 260, 196 P. 454, 456 (1921). Shifting fees to the defendant in an amount based on the outcome rather than on the time the plaintiff's attorneys spent litigating the case has precisely the opposite effect: it favors and fosters litigation to the very end.

One of the clear effects of A.R.S. § 12-341.01(A) and other fee-shifting statutes is to make parties more inclined to settle cases early. *See Wagenseller v. Scottsdale*

court with instructions to redetermine the amount of fees utilizing the lodestar method to make a reasonable award.

Respectfully submitted this 1st day of May, 2002.

Janet Napolitano
Attorney General

/s/ P. Schaack

Daniel P. Schaack
Assistant Attorney General
Attorneys for Defendants-Appellants

ARIZONA COURT OF APPEALS

DIVISION TWO

JAMES J. BURKE, Plaintiff-Appellee, v. ARIZONA STATE RETIREMENT SYSTEM, an Agency of the State of Arizona; the STATE OF ARIZONA; and the ARIZONA BOARD OF REGENTS, an Agency of the State of Arizona, Defendants-Appellants.	2 CA–CV 02-0035 PIMA COUNTY SUPERIOR COURT NO. CV–316479

DEFENDANTS-APPELLANTS' REPLY BRIEF

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TABLE OF CONTENTS

TABLE OF CITATIONS

CASES

STATUTES

RULES

OTHER AUTHORITIES

shifting statute, but that fact does not mean that the common-fund doctrine could not also apply.

Class Counsel also assume that the award of fees that a defendant is ordered to pay to cover the plaintiff's attorneys' fees is *all* that the plaintiffs' attorneys may recover. This is not true. A fee-shifting award against the defendant merely mitigates the amount of fees the plaintiff must pay to the attorney. The plaintiff must still satisfy his or her financial obligations to the attorney.

Finally, Class Counsel insist that there is no difference in the amount of an attorneys'-fees award whether paid by the clients or the opponent. This is not true. Class Counsel ignore United States Supreme Court authority holding that, because different forces are at work, there is no correlation between an award made against an adversary and an award meant to spread fees among the beneficiary class. This dispels Class Counsel's contention that by agreeing to pay a reasonable fee, the State stepped into the shoes of the Plaintiff Class and their obligation to compensate their attorneys.

Because the superior court erroneously based its award of attorneys' fees on a percentage of the fund, this Court should vacate the award and remand, instructing the superior court to use the lodestar method to make a reasonable award.

II. An Award Under the Common-fund Doctrine Comes from the Common Fund; It Cannot Come from the Opponent.

Class Counsel assume that just because there was a common fund involved in this case, the award of fees here actually fell under the common-fund doctrine. That is not true.

The purpose of the common-fund doctrine is to avoid unjust enrichment of the plaintiff class by making each member pay a fair share. *E.g.*, *Kerr v. Killian*, 197 Ariz. 213, 218, ¶ 19, 3 P.3d 1133, 1138 (App. 2000); *LaBombard v. Samaritan Health Sys.*, 195 Ariz. 543, 549–50, ¶ 25, 991 P.2d 246, 252–53 (App. 1998); *Boeing Co. v. Van Gemert*, 444 U.S. 472, 478, 100 S.Ct. 745, 749 (1980); *In re Thirteen Appeals Arising out of San Juan Dupont Plaza Hotel Fire Litig.*, 56 F.3d 295, 305 n.6 (1st Cir. 1995); *Swedish Hosp. Corp. v. Shalala*, 1 F.3d 1261, 1265 (D.C. Cir. 1993).[1]

This goal is accomplished by awarding fees against the fund, not against the defendant. *E.g.*, *Brown v. Phillips Petroleum Co.*, 838 F.2d 451, 453–54 (10th Cir. 1988) ("Fees in common fund cases are extracted from the predetermined damage recovery rather than obtained from the losing party."); *Hobson v. Mid-Century Ins. Co.*, 199 Ariz. 525, 531, ¶ 15, 19 P.3d 1241, 1247 (App. 2001) ("The common fund doctrine is a general rule of equity that 'a person or persons who employ attorneys for

---

[1] *See* other cases cited in Opening Brief at 16–17.

the preservation of a common fund may be entitled to have their attorney's fees paid out of that fund.'") (quoting *LaBombard*, 195 Ariz. at 548, ¶ 22, 991 P.2d at 251, quoting in turn *In re Estate of Brown*, 137 Ariz. 309, 312, 670 P.2d 414, 417 (App. 1983)); *Boeing Co.*, 444 U.S. at 478, 100 S.Ct. at 749 ("a fee awarded against the entire judgment fund will shift the costs of litigation to each absentee in the exact proportion that the value of his claim bears to the total recovery"); *Thirteen Appeals*, 56 F.3d at 305 ("a litigant or lawyer who recovers a common fund for the benefit of persons other than himself or his client is entitled to a reasonable attorney's fee from the fund as a whole.") (quoting *Boeing*, 444 U.S. at 478, 100 S.Ct. at 749); *Cook v. Niedert*, 142 F.3d 1004, 1011 (7th Cir. 1998) ("In common fund cases, after attorneys obtain a settlement for the class, they petition the court for compensation from the fund that has been established for the benefit of the plaintiffs"); *Knight v. United States*, 982 F.2d 1573, 1579–80 (Fed. Cir. 1993) ("[Where] one party has created or preserved a fund for the benefit of others, the others should contribute to the active party's costs. The payment comes from the fund itself, as a prior charge before the beneficiaries receive it.") (quoting *City of Klawock v. Gustafson*, 585 F.2d 428, 431 (9th Cir.1978)).

Awarding fees against the defendant does not spread the fees among the beneficiary class. *B.P. North Am. Trading, Inc. v. Vessel Panamax Nova*, 784 F.2d

975, 977 (9th Cir. 1986); *Jordan v. Heckler*, 744 F.2d 1397, 1400 (10th Cir. 1984). "The common fund theory does not impose additional liability on the losing defendant." *Knight*, 982 F.2d at 1579.

Division One of this Court has explicitly recognized the wall separating fee sharing under the common-fund doctrine, and fee shifting under statutes allowing an award against the losing party. In *Kerr*, the Department of Revenue argued that by enacting a "uniform standard" for fee awards in tax cases, the Legislature had rejected the application of the common-fund doctrine in cases in which A.R.S. § 12-348 applied. The Court rejected this argument, noting the differences between the awards:

> We do not believe our legislature has preempted application of the common fund doctrine. The "uniform standard" the Department refers to governs the shifting of fees to a losing governmental entity and has nothing to do with spreading fees among all the prevailing taxpayers who benefit from a lawyer's efforts. *See Kadish v. Arizona State Land Dept.*, 177 Ariz. 322, 328, 868 P.2d 335, 341 (App. 1993) ("A.R.S. section 12-348 provides when fees shall be awarded against government entities and specifies when fees may not be awarded under the statute, but does not bar awards of fees pursuant to other statutes or equitable theories.").

197 Ariz. at 218, ¶ 22, 3 P.3d at 1138.

The way to spread the fee out among those who benefit from the fund is to take the fee from that fund. Class Counsel allude to this integral feature of the common-

Without a doubt, the award here imposed additional liability on the State. It therefore was not properly made under the common-fund doctrine.

III. The Amount of a Fee Award Differs Depending on Whether the Client or the Defendant Is Paying.

Class Counsel argue that the amount of an attorneys' fees award is the same whether it is a fee-shifting award against the defendant or a fee-sharing award among the plaintiffs. They offer no authority for their position other than their bald statement that "in law and in logic, a reasonable fee is the same fee whether the Class pays or Appellants pay." (Answering Brief at 55.) Law and logic are not on Class Counsel's side. Contrary to their contention, a client's agreement to pay a contingency fee brings into play different economic factors than those involved when the court orders the client's adversary to pay reasonable attorneys' fees.

A contingency fee is a forward-looking arrangement between a client and attorney. It recognizes the risk that the case may not be successful. Without a contingency-fee agreement, the client must pay the fees whether they win or lose. Thus, only the client bears the risk of loss. The contingency fee allows the client who cannot afford attorneys' fees (or simply prefers not to pay them) to avoid having to pay them out-of-pocket. The attorney and client become joint venturers, each sharing the risk of not succeeding: the attorney forgoes the client's promise to pay the fees

and instead agrees to collect the fee from any recovery. This arrangement means that the attorney, too, bears the risk of losing the case. To compensate the attorney for assuming this additional risk, the client agrees to pay an enhanced fee, a specific percentage of the amount recovered.

This shared-risk model does not, indeed cannot, apply in the case of an award against the defendant. The defendant and the plaintiff's attorney do not share risks. Unlike the attorney and client, the defendant and the plaintiff's attorney are not joint venturers; *they are adversaries*. It is unreasonable to argue that a defendant should pay not only for the attorney's time spent in the present case but also to pay for the attorney's time spent in other unrelated and unsuccessful cases.

The court orders an adversary to pay attorneys' fees to a prevailing party based on applicable statutory authorization. The United States Supreme Court has held that an enhancement for contingency is not permitted under federal fee-shifting statutes that award reasonable attorneys' fees to the prevailing party. *City of Burlington v. Dague*, 505 U.S. 557, 567, 112 S.Ct. 2638, 2643 (1992). Applying *Dague*, the Ninth Circuit has explained that while such risk multipliers are appropriate in common-fund cases, they cannot be used in awarding fees under fee-shifting principles: "[T]he private market practice of rewarding attorneys for taking cases on a contingency basis would unduly burden losing parties who are required by statute to pay no more than

The report of the Third Circuit Task Force's—headed by Class Counsel's own expert—is entirely consistent with the Supreme Court's reasoning. While it recommended that fees spread among the clients under the common-fund doctrine be calculated as a percentage of the fund (POF), it nevertheless determined that in fee-shifting cases courts should apply the lodestar approach. *Swedish Hosp. Corp. v. Shalala*, 1 F.3d 1261, 1266–67 (D.C. Cir. 1993) (citing *Court Awarded Attorney Fees*, Report of the Third Circuit Task Force (Arthur R. Miller, Reporter), 108 F.R.D. 237, 255 (Oct. 8, 1985)). "As the Task Force Report explains, a key element of the common fund case is that fees are not assessed against the unsuccessful litigant (fee shifting), but rather, are taken from the fund or damage recovery (fee spreading)." *Camden I Condominium Ass'n v. Dunkle*, 946 F.2d 768, 774 (11th Cir. 1991) (citing *Court Awarded Attorney Fees*, 108 F.R.D. 237, 250 (Oct. 8, 1985)).

Although the State cited and relied on *Dague* and *WPPSS* in the Opening Brief, Class Counsel do not even *cite* them (of the Task Force Report, for that matter) in the Answering Brief, let alone provide any contrary legal argument. They do cite cases that supposedly support the proposition that "[i]n appropriate cases contingency fee agreements will be honored under § 12-341.01." (Answering Brief at 31 n. 83.) The cases do not help Class Counsel. Two of them merely confirm that A.R.S. § 12-341.01(B) means what it says: the court cannot award the successful party more than

that party paid or agreed to pay to the lawyer. *See Pasco Indus., Inc. v. Talco Recycling, Inc.*, 195 Ariz. 50, 65, 985 P.2d 535, 550 (App. 1998); *Marcus v. Fox*, 155 Ariz. 524, 747 P.2d 1223 (App. 1987). Another only holds that fees may be consistent with A.R.S. § 12-341.01(B) even when the plaintiff has a contingency-fee agreement with the attorney. *Sparks v. Republic Nat'l Life Ins. Co.*, 132 Ariz. 529, 545, 647 P.2d 1127, 1143 (1982). The fourth case, *Prendergast v. City of Tempe*, 143 Ariz. 14, 691 P.2d 726 (App. 1984), is not on point at all. None of these cases endorses Class Counsel's argument that the losing defendant should pay the same enhanced contingent fee that the plaintiff agreed to pay to the attorney.

Understanding the distinction between the two types of fee awards also disposes of Class Counsel's argument that in making fee awards, courts should not judge the reasonableness of the amount. Class Counsel argue that "[t]he function of judges in fee litigation is not 'to determine the equivalent of the medieval just price', but 'to determine what the lawyer would receive if he were selling his services in the market rather than being paid by court order." (Answering Brief at 40 (quoting *In re Continental Ill. Sec. Litig.*, 962 F.2d 566, 568 (7th Cir. 1992)). In *Continental Illinois*, the court was analyzing a fee-spreading award under the common-fund doctrine, in which the attorneys sought compensation from the fund they helped create. *Continental Ill.*, 962 F.2d at 568. They were not seeking a fee-shifting award

against the defendants (no fee-shifting statute applied). Since *Continental Illinois* was assessing the fee that clients would pay to their attorneys, it made sense to apply the marketplace analysis. But it does not make sense to apply that analysis to an award against the defendant because there is no relevant marketplace. Defendants do not sue themselves and do not go into the market to hire attorneys to do that.

When a court awards fees against one party in favor of that party's adversary, then it *is* that court's duty to determine the reasonableness of the fee. The courts recognize this by applying the lodestar method.

IV. A Statutory Award of Fees Against the Opponent Does Not Preclude Counsel from Collecting the Rest of the Fee From the Client.

Class Counsel asserts that the State placed them in an ethical dilemma by offering to pay reasonable attorneys' fees. They argue that their duty to their clients required them to accept the offer and it would be unjust if the award against the State was less than what their clients would have had to pay. This argument fails not only because it is based on an incorrect premise but also because Class Counsel always had an ethical duty to seek fees from the State.

A. Class Counsel's Argument is Based on a Faulty Premise.

A necessary premise of Class Counsel's ethical argument is that once Class Counsel was offered or awarded an amount of fees from the State that was less than

this Court. Instead, the Agreement left the question to the court to apply the correct methodology by determining the proper basis for the award.

To determine the correct methodology, the court must determine whether the award encompasses fee sharing or fee shifting. If it was a fee-sharing award under the common-fund doctrine, then the POF method would be appropriate. But this award does not come from the common fund, it comes from the opponent. The award is a fee-shifting one: it shifts a portion of the fees from the Plaintiffs to their adversaries, the State. Therefore, A.R.S. § 12-341.01(A) applied and the lodestar, rather than the POF method, should have been applied. The trial court erred in determining otherwise.

CONCLUSION

This Court should vacate the Judgment of $3,708,446.50 to Class Counsel and remand to the superior court with instructions to use the lodestar method to make a reasonable award.

Respectfully submitted this 23rd day of July, 2002.

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STATE'S MISREPRESENTATION OF PROFESSOR SILVER'S SEMINAR PANEL REMARKS

State's Response, pg. 15, line 20 - pg. 16, line 7:

Professor Silver believes that State Bar Ethics have little place in determining reasonable attorneys' fees in class actions.

> *Fees in class action have nothing to do with legal ethics and are not governed by ethical principles. . . .If such a fee is inconsistent with the state bar ethics rules that limit fees to a reasonable amount, I say too bad for them. . . .My point is simple. Judges should also ignore the fee rules. They should set fees in class actions with an eye to maximizing the net recovery of class members and they should not care one whit about the criteria that state bars have adopted.*

Actual text of Professor Silver's remarks from pgs. 56-58 of Exhibit F to State's Response:

> A lot of gross exaggeration has taken place here about what the fees are in class actions. Most class actions are very small. They settle for a couple of million dollars and the fees tend to be a half a million dollars or less. What we would really like to know is why class actions are like that. Why is it that so many class actions settle for small sums?
>
> One possible reason is that fees are too small to justify the risk that lawyers would incur to take large cases and prosecute them successfully.
>
> * * *
>
> Risk aversion is something that you haven't heard anyone talk about on this panel. That's because in individual plaintiff representations, risk aversion really isn't a problem. Lawyers who handle personal injury cases have diversified portfolios. They're like stockholders. They have lots of shares in lots of different companies, so they have a predictable rate of return on their portfolios.
>
> Class action lawyers aren't like that. They have a relatively small number of cases, each of which represents a very large nondiversifiable risk. . . . Now,

the rational thing for a risk averse person to do when faced with large risks is to settle cheaply unless highly motivated to do otherwise.

* * *

The most significant problem we have in class action litigation today is not over, but under-compensation of lawyers, as well as a failure to tie lawyers' compensation to the risks that they incur in these cases. Why do we have this problem? Because everybody thinks about fees in class actions in the wrong way. Everybody thinks about fees in class actions in terms of legal ethics. *Fees in class actions have nothing to do with legal ethics and are not governed by ethical principles.* Class actions are about due process of law, not legal ethics. The purpose of the class action is to insure that a person who has not actually appeared in court is bound only when he or she is adequately represented.

Accordingly, the manner of regulating fees in class actions should be calculated with an eye to insuring that every class member is adequately represented. What does that mean? It means we should regulate the fee in a way that encourages lawyers to maximize the absent class members' net recovery. . . .That's what due process requires.

If such a fee is inconsistent with the state bar ethics rules that limit fees to a reasonable amount, I say too bad for them. Judges routinely—I emphasize routinely—ignore state bar ethics rules when managing class actions because they understand that class actions are not about state bar ethics rules. They're about due process.

Every state in the country has something called the aggregate settlement rule. But no judge presiding over a class action has ever applied it to a class action settlement. Why? Because the aggregate settlement rule allows a group lawsuit to settle only with the unanimous consent of every client who participates. Can you imagine the difficulty of getting every class member to consent to a class-wide settlement? It would never happen. If we're going to have class action settlements at all, we can't apply that rule. So judges don't. Judges also ignore the duty of loyalty rules in class actions. They allow lawyers to do all kinds of things in class actions that lawyers representing individual clients would not get to do. They also ignore the duty of obedience.

My point is simple. Judges should also ignore the fee rules. They should set fees in class actions with an eye to maximizing the net recovery of class members and they should not care one whit about the criteria that state bars have adopted. I explain all of this at much greater length in a forthcoming article in the *Tulane Law Review* and I have explained it in other writings I have already published on class actions.

Why are fees in class actions so controversial if, as I believe, they are too low? It's because when fees in class actions are handled as they should be, in a manner that's calculated to maximize the value of the claims, defendants get upset. The defendants are the people who are here today. You, the defendants, don't want fees in class actions to be handled in a manner that maximizes the value of class actions. You, the defendants, want fees in class actions to be handled in a way that minimizes the value of class actions. So you complain when judges try to tie the fees to the recovery. That's one reason that fees are controversial.

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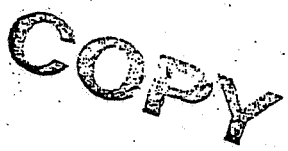
File No. 8032-04

February 13, 2002

PRIVILEGED SETTLEMENT COMMUNICATION PROTECTED BY RULE 408, ARIZONA RULES OF EVIDENCE

VIA FACSIMILE; ORIGINAL BY MAIL

Janet Napolitano, Attorney General
Office of the Attorney General
1275 West Washington
Phoenix, AZ 85007



VIA HAND DELIVERY

Michael F. Kempner
Chief Counsel/Tax Section
Office of the Attorney General
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Re: *Estate of Helen Ladewig v. Arizona Department of Revenue*

Dear Mr. Kempner:

In our continuing effort to reach a settlement in this case which will satisfy the Rule 23, *Ariz.R.Civ.P.* requirements of fairness, adequacy and reasonableness, we submit the following settlement offer. We request that the Attorney General and you communicate this offer to your client without delay and advise us of your client's decision. In view of ongoing budget discussions, and the mounting statutory interest cost that is now estimated to be between $65,000 and $90,000 a day, we understand that time is of the essence to the State.

We would like to emphasize that the following offer is tailored to your client's announced litigation objective of spreading the payment of the refunds in this matter over five years. This

offer provides the State with the certainty of that outcome as well as the opportunity to realize substantial interest cost savings —a benefit which the State would not enjoy even if it were otherwise totally successful in its current litigation theory that it can require each of the taxpayers to document their refund claim even though the State has the ability to do so from its own records.

1. Refunds. Refunds (taxes and accrued compound statutory interest) will be processed and paid to class members in five installments, with the payment of the first installment commencing 60 days after the Judge's ruling under Rule 23 approving the settlement as fair, reasonable and adequate.

2. Interest. In computing refunds, the statutory compound interest rate will continue to apply until the date the Judge's order approving the settlement becomes final. From and after the date of the final order approving the settlement, simple interest will accrue on the unpaid balance of the refunds (*i.e.*, taxes and accrued compound statutory interest) at the reduced rate of four percent per annum.

3. Claims Process. A simple claims verification process will be agreed upon, including simplified procedures to facilitate refund payments in the case of closed estates and class members under a disability. To the maximum extent possible, the Department will use a computerized process for the calculation and payment of refunds.

4. Attorneys' Fees and Costs. The attorneys' fees and costs will be borne by the taxpayer class. Attorneys' fees and costs of the taxpayer class will be determined by the Court, upon notice and opportunity of the class (only) to be heard on that issue. The percentage awarded by the Court will be subtracted and paid from each of the installment refund payments when same are paid to class members.

5. Claims Bar Date. All class members or their representatives must complete and file with the Department of Revenue a simple verification form on or before April 15, 2005, in order to receive refunds. A failure to file the verification form with the Department of Revenue on or before that date will result in the denial of that class member's claim.

6. Definitive Written Agreements. This offer is conditioned upon reducing the basic points set forth above into a definitive agreement, including customary, detailed provisions governing notice, notice verification, verification filing audit, refund payment settlement administration and a process to resolve disputed refund determinations that satisfies

the requirements of Rule 23 and is approved and ordered implemented by the Court.

We trust that you appreciate the fairness and simplicity of the settlement proposal and will urge your client to accept it.

Thank you for your careful consideration of the settlement proposal. Warmest professional regards.

Very truly yours,

Randall D. Wilkins

Randall D. Wilkins

STATE OF ARIZONA

OFFICE OF THE ATTORNEY GENERAL

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March 19, 2002

PRIVILEGED SETTLEMENT COMMUNICATION PROTECTED BY RULE 408, ARIZONA RULES OF EVIDENCE

VIA FACSIMILE; ORIGINAL BY MAIL

Randall D. Wilkins, Esq.
Bonn & Wilkins, Chartered
805 North Second Street
Phoenix, Arizona 85004

Re: Estate of Ladewig v. Arizona Department of Revenue

Dear Randy:

Thank you for allowing the Department of Revenue to respond to your initial settlement offer. The State has attempted to include some of the proposals in your offer including the incorporation of a simplified claims procedure and the assumption of reasonable attorney fees and costs by the class. We have further attempted to clarify the notice, claims and refund processes. The following terms will need to be tightened up when reduced to a settlement agreement and will be subject to State, class and Court approval. We look forward to working with you to resolve this matter as expeditiously as possible.

1. Notices. The Department will send two formal notices to class members and a third mailing to class members advising them of a calculated refund amount as described below. The first notice (Notice 1), by mail and publication, will be to advise the members of the action and to give them an opportunity to opt out. The second notice (Notice 2), by mail and publication, will be to give notice to the class members of this settlement agreement and give a deadline for them to file an objection to the settlement. The second notice shall also advise class members, who have not received notice by mail, that they need to file a claim form designed by the Department of Revenue if they wish to be included in any class recovery.

The third mailing will be sent only to class members who did not opt out and whom either appear on the Department's records or who filed a claim form as a result of the second notice.

2. Class. Everyone who does not opt out of the class shall be a member of the class, whether they file a claim or not. However, those class members who do not appear in the Department's records and who do not timely file a claim following the second notice will not participate in any recovery. The Department shall publish notices (Notices 1 and 2) to class members in newspapers of general circulation including the Arizona Republic, Arizona Daily Star and the East Valley Tribune. The Department shall also publish notice to class members on its web site and in at least one national media outlet and shall actively notify tax trade journals and tax services, including national and state publications such as the Arizona and American Bar Associations and the American Institute of Certified Public Accountants. To opt out of the class, a person must file the documents required by the Court on or before September 1, 2002 (Notice 1). Persons who do not appear on the Department's list of members of the class and who believe they are entitled to a calculated refund for one or more of the tax years in question shall have until October 1, 2002 to file a claim on a form designed by the Department of Revenue. (Notice 2). The form will require proof of entitlement to a refund.

3. Refunds. The total amount paid by the state to, or on behalf of the taxpayer class, shall not exceed a cap of $350 million, as may be reduced below. The taxpayer class shall bear all expenses for attorney fees, taxable costs and other expenses, and costs of administration. Each calculated refund payment (taxes and accrued interest) shall be reduced by a pro-rata share of these expenses. If the total amount of calculated refund payments, less expenses, exceeds the cap, each refund payment shall be reduced on a pro-rata basis so that the total amount paid does not exceed the cap. In no event shall the total amount paid by the state exceed the actual amount of calculated refunds, less expenses, and as otherwise adjusted by the terms of this offer. Any refund payment shall first be credited against any amount of tax, penalties or interest which may be due to the state or the Internal Revenue Service, or used as a setoff against any debts which the class member may owe to the state or a court. The cap shall be reduced by the amount of refunds due to members of the class who timely opt out. The amount to be deducted from the cap for each member of the class who opts out shall be the amount of refunds requested by the person in accordance with Title 42, Arizona Revised Statutes. Payments will be made in accordance with the following terms in four annual installments with the first payment commencing no later than December 31, 2003. Provided, however, if a claimant is required by the process below to provide information and does not provide the information prior to August 1, 2003, the first payments will be delayed until information is received and processed. In addition, adjustments in refund amounts may be required in years two through four to account for (1) changes in the estimated amount of costs of administration as set forth below, (2) changes in the total amount of refunds due to resolution of disputes by members of the class in the amount their refund and (3) changes in the total amount of the refunds owing to those who opted out of the class due to resolution of their disputed refund requests.

4. Claims Process. The Department of Revenue will employ expert consultants to attempt full recovery of all necessary data from the dividend tapes received from the Internal Revenue Service for tax years 1986 through 1989. The Department will use its microfiche records to digitize the following missing data: tax year 1986 IMF and IRTF data and tax year 1988 Arizona keyed data. The Department will mail notices (pursuant to paragraph 1 above) to everyone who appears from its electronic records to have (1) received dividend income from one or more corporations not doing 50% or more of its business in Arizona and (2) paid tax to Arizona for one or more of the tax years in question on dividend income received from such corporations.

The Department will use all of its electronic data, including digitized microfiche data and restored IRS data, to calculate a refund amount for each class member. To calculate the refund amount the Department may use formulas that will be agreed to by the parties or approved by the Court. Once agreed to by the parties or approved by the Court, the class members will not be allowed to contest the formulas. The Department will then advise each participating class member of (1) the amount of their refund, (2) the information used to calculate the refund, (3) that the refunds will be subject to the cap and reduced by pro-rata shares of attorney fees, taxable costs and other expenses, costs of administration and subsequent year adjustments, and (4) the process by which the class members may present evidence of missing dividends or incorrect information concerning their income, tax rate and tax paid, as used in calculating their refunds. Following proof of the corrected information, the Department will recalculate all refund amounts and then do a pro-rata recalculation for the purpose of the cap, including reductions for attorneys' fees, taxable costs and other expenses, costs of administration and subsequent year adjustments.

5. Dispute Resolution Process. The parties agree to develop a dispute resolution process for determination of disputed dividends or other disputed information that will be used in the formulas to calculate an individual's calculated refund amount. All costs of the dispute resolution process will be included in the costs of administration which are expenses of the class as outlined above.

6. Attorneys Fees. Attorneys for the class shall petition the Court for approval of reasonable attorney fees, taxable costs and other expenses, all of which are expenses of the class as outlined above.

7. Costs of Administration. Prior to issuing any refund checks, the Department will estimate the total cost of administration and will subtract a pro-rata share from each payment. Annually, the estimate will be adjusted, if necessary, with a concurrent adjustment of each payment.

8. Unresolved Issues. The parties agree that unforeseeable issues may arise which will need to be resolved and that they will work together in good faith to find a solution. If any issues cannot be compromised then the matter will be presented to the Court for determination.

We look forward to hearing from you as soon as possible with regard to this counter-offer.

Sincerely,

Michael F. Kempner
Chief Counsel
Agency Counsel Division, Tax Section

MFK:plr
cc: Steve Shiffrin
#362080 v5 - LADEWIG COUNTEROFFER

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File No. 8032-04

May 22, 2002

PRIVILEGED SETTLEMENT COMMUNICATION PROTECTED BY RULE 408, ARIZONA RULES OF EVIDENCE

VIA FACSIMILE; ORIGINAL BY MAIL

COPY

Michael F. Kempner
1275 West Washington
Phoenix, Az 85007

Re: *Estate of Helen Ladewig v. Arizona Department of Revenue*

Dear Mike:

In an effort to hopefully move this settlement process forward, Gene and I wanted to follow up on our recent conversations concerning Paragraph 14 of the Stipulation of Settlement which deals with the award of attorneys' fees to class counsel.

Based upon our conversations, we understand that the Attorney General is insisting upon being heard on the issue of class counsel's Motion for a Common Fund Fee Award that will be determined by the Court. As Gene and I explained to you, that is simply unacceptable to us for several different but equally important reasons. Because we understand that you will need to discuss this issue with many people, Gene and I thought it might be helpful to put our thoughts down on paper so that you could more accurately and conveniently communicate our concerns to all of the people with whom you need to speak. It is not our intention to prompt a response from you at this time. We understand you may have a different view of the issue and you do not need to share it with us now. We will not claim you waived it because you did not respond to this letter.

First, we have practical concerns with the State's position. As we informed you in our

conversation, the settlement structure the State has requested and which we have agreed upon in this case involves installment payments that will be spread out over four years. The agreement therefore necessarily contemplates that a substantial investment of time will be spent by class counsel in the next four years as the more than 600,000 Arizona taxpayers' claims are processed. Based upon our experience in other class actions involving tax refunds, we believe it is highly likely we will incur substantial time simply responding to class members' legitimate concerns. In that regard, the settlement we are attempting to reach is a complicated one, and the notice that class members will receive is necessarily detailed and involved. It is not unreasonable to assume that the class members will have many questions. We therefore anticipate that considerable equipment and personnel expenses will be incurred on our end. Thus, in order to fulfill our end of the settlement for the class, class counsel must be assured of payment. We simply cannot carry the burdens which the agreement imposes upon us in the future without assurance of payment. Certainly, you and your client, the Department, recognize the significance of this burden as demonstrated by the size of the administration cost reserve you have negotiated under the agreement. Simply put, we do not have the economic resources to go without payment while the Attorney General, with limitless resources, appeals our fee award like it did in the *Kerr* case.

Please understand that although we are more than willing to defend our fee request against any objections that might be raised by the class members (the class contains many wealthy and experienced attorneys and other sophisticated investors with access to legal representation), the problem with the Attorney General objecting to our fees is that unlike any of the class members, the State does not have to bond over any judgment that might be entered in our favor if it takes an appeal. We could therefore be forced to perform services for four years without any payment. In essence, the State could economically kill us while our clients go without effective representation. As we explained in our conversations, we simply cannot, in good faith, enter into an agreement that we know we cannot fulfill if the Attorney General decides for whatever reason to appeal our fee award.

In addition to the above practical considerations, we are also concerned with the Attorney General's legal position. First, as we explained to you, the Attorney General's assertion of the right to object to class counsel's fees is contrary to both Arizona and federal law. As we also explained, this issue was extensively litigated in *Kerr* v. *Killian*, 197 Ariz. 213, 3 P.3d 1133, where the Department objected to a common fund award to plaintiffs' counsel, and ultimately appealed the award. Plaintiffs' counsel moved to dismiss the Department's appeal, contending the Department lacked standing and was not an aggrieved

party and could not object to the common fund award. The Court of Appeals determined that because the Department would be required to bear the cost of notice, if the common fund award was upheld, the Department was "aggrieved" and could be heard on the issue:

> We believe that the Department has carried its burden of demonstrating that it is aggrieved by the judgment. First, there is the matter of having to pay 20% of 26 refunds out of the Department's own funds. Then, as the Department pointed out in its response to the motion to dismiss, the judgment required it to undertake multiple mailings that cost between $10,000 and $15,000 more than it would have otherwise had to pay. Finally, the Department must undertake the administrative task of withholding part of each refund and periodically accounting for and remitting the amounts withheld to the taxpayers' counsel.

197 Ariz. at 217. In this case there is no "aggrievement" as a matter of law because there is a settlement.

Moreover, the Court squarely held in *Kerr* that the Department lacked standing to challenge the award on the basis it violated the taxpayers' due process rights. The Court ruled the Department lacked standing to seek reversal on this basis because the right to due process asserted did not belong to the Department. Similarly, the Court rejected the Department's attempt to act as the protector of the taxpayer:

> The Department's attempt to assume a protective role as to non-party taxpayers can hardly be characterized as the manifestation of a substantial relationship in view of the Department's unceasing efforts over the last nine years to deny these taxpayers any refunds at all.

The *Kerr* decision, which collaterally bars the Attorney General's position here, is consistent with federal law. In *Boeing v. Van Gemert*, 444 U.S. 472 (1980), the United States Supreme Court upheld the rule, well established in prior cases, that in a class action a defendant does not have standing to dispute the fee award between the class and their counsel:

> The judgment on the merits stripped Boeing of any present interest in the fund. Thus, Boeing had no cognizable interest in further litigation between the class and its lawyers over the amount of the fees ultimately awarded from money belonging to the class.

444 U.S. at p. 482, fn. 7.

The Attorney General's insistence upon a right to be heard in connection with the award of class counsel's fees is especially troublesome here given the Attorney General's own position in prior cases. As we discussed, we have confirmed with lead counsel in both the *Cement* and *Petroleum Antitrust* cases, in which the Arizona Attorney General participated, that one of the terms of the settlement insisted upon by the Attorney General was the condition that the defendants could not be heard on the Attorney General's fee request. Given that the Attorney General has both recognized and insisted upon adherence to the general rule that the losing party in a common fund case cannot interject itself into the fee award between the class and their counsel in cases in which it was involved, we do not know why this has become a deal breaker for the Attorney General in our case.

Finally, and most importantly, there are ethical issues with the Attorney General's position. In this case, we will have a continuing duty to provide ongoing legal services to the 600,000 members of the class for a period of four years. As indicated above, the magnitude of the professional resources and the amount of expenses to deliver those services without any problems in settlement administration will be extraordinary. If problems should arise, an already enormous sum will become even greater.

The decision of what the members of the class are willing to pay for class counsel's prior and future services is solely a matter for the Court and those who are paying for the services. We believe it is professionally improper for the Attorney General to attempt to control both sides of the settlement — *i.e.* acting as counsel to the Department in the ongoing court supervised settlement administration and accounting proceedings, on the one hand, while attempting to control the breadth and depth of legal resources available to its adversary by attempting to withhold or influence the amount that will be paid to counsel for the opposing side.

Were the Attorney General to maintain the position that she is entitled to oppose or

appeal the amount of fees to be paid by her client's adversary, it is our position that such conduct would constitute unprofessional conduct and would place class counsel in a professionally untenable position. Here, it has been suggested that the Attorney General wishes to maintain a position that will enable her to control directly the amount of legal services that class counsel will be able to deliver to the class by controlling the payment of fees and expenses. Viewed from the other perspective, class counsel would be subject to condemnation for permitting counsel for the opposing party to direct or regulate the quality and quantity of legal services available to the class. Such conduct would violate, *inter alia*, ER 1.3 of Rule 42 ("A lawyer shall act with reasonable diligence and promptness in representing a client."); ER 2.1. ("In representing a client, a lawyer shall exercise independent professional judgment. . .."); ER 5.4(c) ("A lawyer shall not permit a person who . . . pays the lawyer to render legal services for another to direct or regulate the lawyer's professional judgment in rending such legal services"); ER 8.4(d) ("It is professional misconduct for a lawyer to engage in conduct that is prejudicial to the administration of justice.")

In conclusion, counsel for the class has an obligation to the class to maintain their professional independence. *See* ER 2.1. The Attorney General under the facts and circumstances of this case cannot legitimately claim any cognizable interest in controlling or even attempting to influence what the class pays its lawyers. Here, both the law and the settlement provide class members with a simple procedure "to assert their own rights." *Kerr*, 3 P.3d at ¶16. Indeed, under the agreement, a class member does not even need to appear to assert his or her rights. Finally, it is worth emphasizing that this is a class action. Judge Katz, an experienced trial judge acts as the fiduciary for the class. *See Manual for Complex Litigation*. He will not award an unreasonable fee.

Thank you for your professional cooperation. If you need additional information, please feel free to contact us.

Very truly yours,

Randall D. Wilkins
For the Firm

cc: Eugene O. Duffy, Esq.

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File No. 8032-04

June 10, 2002

PRIVILEGED SETTLEMENT COMMUNICATION PROTECTED BY RULE 408, ARIZONA RULES OF EVIDENCE

VIA FACSIMILE; ORIGINAL BY MAIL

Michael F. Kempner
Chief Counsel Tax Section
Office of the Attorney General
1275 West Washington
Phoenix, Arizona 85007

COPY

Re: *Estate of Helen H. Ladewig v. Arizona Dept. of Revenue*
No. TX97-00075

Dear Mr. Kempner:

As we informed you in our letter of June 5, 2002, we would be responding to the misstatements contained in the letter to us of June 5, 2002, from the Attorney General's office ("Attorney General"). This letter sets forth our response, and also supplements our prior letters to you of May 22, 2002, and June 4, 2002. However, before turning to that response, we emphasize that if there is a good faith desire to consummate formally the agreement in principle previously reached, it can be done and we are willing to do what it takes to get it done. But, to get it done requires communication — something which seems to have been missing since the conclusion of our meeting on May 17, 2002. It also takes a common sense appreciation and respect for the principle that when one party agrees to settle an entire matter that party is agreeing to a binding resolution of the entire matter.

The Attorney General's letter raises several issues that require a response. We will start with the Legislative appropriation and timing issues first because until those issues are

resolved, everything else is academic.

We are stunned by the Attorney General's newly announced position that a settlement in this matter should be contingent upon an annual appropriation by the Legislature. Not only is this position contrary to the Department of Revenue's (the "Department") settlement counter-offer of March 19, 2002, it is also contrary to the express representations of both you and Mr. Shiffrin that the counter-offer had been fully approved all the way up the line and required no legislative involvement. You specifically informed us that its implementation and execution were not conditioned in any way on a legislative appropriation.

The attempt to articulate a justification for this "legislative appropriation" point during our phone call on late June 5, 2002, is plainly illogical and directly contrary to both your and Mr. Shiffrin's positions in previously reaching an agreement in principle. As we are sure you recall, Mr. Shiffrin insisted on setting the reserve for costs of administration so that the projected costs would be fully covered, even including a significant margin to cover unforeseen contingencies. The very rationale for this approach was always to insure that absolutely no legislative appropriation of funds would be required.

The Attorney General's letter on this point is also inconsistent with the long ago agreed upon provision insuring that the Court retained jurisdiction, *inter alia*, to enforce the agreement in accordance with its terms. It now appears that the Attorney General's office is proposing an illusory settlement — the State is off the hook if the Legislature fails to appropriate even modest funds in any of the four years. Such uncertainty — as the State now claims "must be understood" to be an express condition of the settlement — plainly does not meet the requirements of Rule 23 governing class action settlements, and cannot be approved by the Court. It is analogous to (but significantly worse than) the initial failed Arthur Anderson/Arizona Baptist settlement, but we are being asked to assume the very role which resulted in public criticism of the Attorney General in that case.

With respect to timing, the Attorney General's plea for more time rings hollow.[1] The

[1]If the Attorney General's office was sincerely interested in maximizing the economic recovery of the class under the agreement in principle, rather than seeking yet another delay, the Attorney General's office would have already joined with us in submitting final settlement documents to the Court for approval.

cost of the unexplained delay now being sought is directly underwritten by our clients. If the cap is exceeded, each day that the Attorney General's office delays reduces the value of the settlement to the class.[2] The Attorney General's office has now had over two weeks to review the revisions to documents that it itself had previously redrafted and spent hours revising line-by-line with us during joint editing sessions which concluded on May 17, 2002. The Stipulation of Settlement flows directly from the Department's written settlement counter-offer of March 19, 2002. The terms of that counter-offer have been represented to us as having been authorized and approved all the way up the chain, including the Governor herself. It is inconceivable to us that significant time is needed to obtain the "necessary authorizations and approvals" for the terms of a settlement document that have already been authorized and approved.

We have no idea why the Attorney General's office is revisiting the issue of Professor Coffee. Weeks ago it was made clear that the Attorney General would not stipulate to the appointment of Professor Coffee, a nationally recognized expert relied upon by Congress and the United States Supreme Court for decades, as a Special Master. That question was resolved and nothing in the revised documents which were delivered to you on May 20 and 21, 2002 has any provision to the contrary.

Also, if the Attorney General's office were truly concerned with the economic interests of the class which it now touts, it would have invested the time to satisfy itself of the settled tax treatment under federal law governing the reporting of the net amount to be paid to class members under the agreement in principle and stipulated to that treatment. Reporting of the "net" refund obviously improves the economic value of the settlement of the class and is clearly justified by existing federal law. However, instead of stipulating to the treatment, the Attorney General's office has taken a hands-off approach, leaving it to class counsel to ghost write a submission for its client. How does that square with the Attorney General's purported "need" to now protect the taxpayers from their own lawyers?

[2]We emphasize that we make reference to the delays of the Attorney General's office. We do so because we witnessed first hand the Department's commitment on May 17, 2002, to have the settlement documents completed before the last hearing on May 23, 2002. We then also witnessed Mr. Shiffrin's post-hearing affirmation on May 23, 2002, to get it done before our June 10, 2002 hearing.

We will now address the remaining issue raised in your letter, the Attorney General's insistence upon the right to interfere in the attorneys' fees the class members pay to their own attorneys, even though she claims she does not know whether such right will be exercised.

Contrary to the assertion in your letter that we informed you the Attorney General's insistence upon a right to interfere with the attorney fee issue may be a "deal breaker," it was actually the Attorney General's office that told us this condition, which was not even raised in the State's prior correspondence establishing the agreement between the parties, was in fact a "deal breaker." For all the reasons we will explain, we have concluded the Attorney General's insistence upon this belated condition is not in good-faith and we regret that the Attorney General has now decided to make it a "deal breaker." Moreover, given the fact that in every other significant class action case in which the State has participated as a plaintiff, the Attorney General has also insisted that the defendants could not object to the State's attorneys' fees, we find the Attorney General's position in this case to be particularly disingenuous. With those points in mind, we will now turn to the substance of your letter in which you attempt to justify the Attorney General's standing to object to our attorneys' fees — fees the State admits it is not paying, and which it has no right to object to under existing Arizona law. The only explanation the Attorney General has offered to justify its insistence upon this improper condition is its alleged concern for the class members. A brief discussion of the history of this case is in order first, because it places the Attorney General's alleged "concerns" in context.

As you know, the State and the Department have now fought Mrs. Ladewig's claim for almost 13 years. Even after the United States Supreme Court's decision in *Fulton*, which made the unconstitutional discrimination in Arizona's tax scheme unmistakable, the State continued to oppose refunds to anyone, including Mrs. Ladewig, and vigorously contended that Arizona's scheme was distinguishable. After the State lost the merits of Mrs. Ladewig's claim, the Department steadfastly asserted that Mrs. Ladewig was the only taxpayer entitled to a refund and that no other Arizona taxpayers could recover a refund of what was by then an indisputably unconstitutional tax, even though the State is under a clear statutory duty to refund illegal taxes. Indeed, even after the State lost its argument that no one but Mrs. Ladewig was entitled to a refund, and even after the Arizona Supreme Court had rejected the State's Motion to Reconsider its ruling, the State continued to oppose refunds by next claiming each and every class member had to prove his or her refund claim, even though the State conceded there was no duty of taxpayers to keep records beyond four years, and the State admitted it knew that many, if not all, of the taxpayers no longer had the records

necessary to support such a claim. And, finally, after we reached an agreement in principle that provided for a cap on the State's liability (and therefore shifted the cost of further delay to the taxpayers and away from the State), the State is now seeking to delay final resolution of this settlement indefinitely to the detriment of the class members.

Given all of this adversarial history, the Attorney General's ostensible reason for insisting upon the "right" to interfere with our fees and to appeal any judgment that might be entered in our favor, without posting a bond — a professed "concern" for the class members — once again rings hollow. It is particularly hollow in light of the fact that we have already informed you (repeatedly) that our written Fee Agreement with our client, which, although it is not binding on the class, limits any request we might make to 40 percent (which is the most we could ever ask for even though we have already informed you we will be requesting less than 40 percent). Lastly, although the Attorney General claims to be concerned about our fees, you refuse to tell us what the Attorney General believes is a reasonable fee, and instead continue to assert a "right" to interfere with our attorneys' fees.

In advancing this new condition, the Attorney General has acknowledged that no one has reviewed the appellate record in *Kerr*. Similarly, no one has reviewed the authorities which clearly establish the benchmark percentage at 25% for fees (not including costs) and the factors for increasing that percentage in setting attorney fee awards in cases like the instant one. Here, it is simply inconceivable that the Attorney General could honestly articulate a legitimate position in opposition to a petition for attorneys' fees and costs that does not exceed the benchmark.

In fact, based on the uncontroverted history of this case, the overwhelming weight of authority fully supports a fee award substantially above the benchmark percentage. Such result would be justified solely on legal services already performed by class counsel. Moreover, unlike the typical common fund settlement, there are significant legal services to be performed for the class over the next four years by class counsel. Consequently, a benchmark range attorneys' fee award would result in class counsel being substantially undercompensated for their past and future services in this case.

Quite frankly, given the history of this case, which unambiguously demonstrates the Attorney General's willingness to do everything in her power to deny the class members' their refunds, the Attorney General's alleged "basis" for her interference in the attorneys' fees issue is risible. But, more importantly, it is ethically impermissible — as you know, the

Attorney General simply cannot represent two parties whose interests clearly conflict, and she cannot advance arguments purportedly on the class members' behalf while she is still representing the Department in the litigation and under the settlement. Moreover, it is also the very same "justification" that was presented to and squarely rejected by our Court of Appeals in the *Kerr* case, and the State and the Attorney General are therefore collaterally estopped to argue it now. If the Attorney General has overlooked the *Kerr* Court's ruling on this point, we will repeat it for the Attorney General so that the record is absolutely clear:

> **The Department's attempt to assume a protective role as to non-party taxpayers can hardly be characterized as the manifestation of a substantial relationship in view of the Department's unceasing efforts over the last nine years to deny these taxpayers any refunds at all. (Emphasis added)**

Indeed, we believe that it will be as painfully apparent to anyone else who looks at this issue as it is to us that the Attorney General's purported "concern" for the class members is simply designed to conceal the Attorney General's true agenda, which, we can only conclude, is either to punish us as lawyers for bringing this case (and thereby deter other attorneys from pursuing similar claims) or, even more troubling, to improperly influence our independence and restrict our ability to effectively and zealously represent out clients in the inevitable disputes that will arise in the course of administering the settlement. Needless to say, either objective would be patently improper. If you believe we are being overly cautious in this matter, you should consider the following history and circumstances:

The Attorney General's reliance upon the *Kerr* case as "support" for her asserted standing to object to our fees actually confirms our suspicions that an ulterior motive exists here. As we told you in our conversations, the Attorney General's office has too many good lawyers to have missed the obvious and critical factual distinction between this case and the *Kerr* case. In *Kerr*, the Court ordered the Department, over the Department's vigorous objection, to segregate 20 percent of federal employees' refunds and to pay them to the attorneys. The Department pointed out to the Court the significant financial and administrative burdens the order imposed on it, and our Court of Appeals ruled the Department was therefore an "aggrieved" party and was entitled to be heard on the issue because if the Department was successful and could establish that a common fund award was not appropriate, the Department avoided these costs:

> We believe that the Department has carried its burden of demonstrating that it is aggrieved by the judgment. First, there is the matter of having to pay 20% of 26 refunds out of the Department's own funds. Then, as the Department pointed out in its response to the motion to dismiss, the judgment required it to undertake multiple mailings that cost between $10,000 and $15,000 more than it would have otherwise had to pay. Finally, the Department must undertake the administrative task of withholding part of each refund and periodically accounting for and remitting the amounts withheld to the taxpayers' counsel.

Here, in stark contrast, the Department is assuming these obligations voluntarily, pursuant to a settlement agreement that provides numerous benefits to the State. Moreover, the Department's costs are being paid by the class members! Relying upon *Kerr* under these circumstances cannot be defended. What is going on here?

As we have already noted, the *Kerr* Court pointedly ruled that the State did not have standing to assert the individual due process rights of the taxpayers given the adversarial history between the State and those very same taxpayers. The issue the State could argue in *Kerr* —whether the common fund doctrine applied in an income tax refund case — has now been conclusively decided against the State. The apparent "issue" the Attorney General wants to argue here — the amount of fees the class members, and not the State, pay to their lawyers — exceeds her constitutional duties and authority.

In order to avoid any misunderstanding, we want to emphasize one point. As we have repeatedly told you, our problem with the Attorney General interfering with our fees in this case does not arise because of a concern about a legitimate fight over our fees. The class members will have the right to challenge our fees, and Judge Katz, who acts as a fiduciary for the class, retains the ultimate say on the matter. Moreover, the class is comprised of sophisticated members who have the economic means, ability and incentive to challenge any fee request we make if it is unreasonable. Rest assured, our fees will be vigorously and properly scrutinized without the Attorney General's involvement.

Instead, the problem with the Attorney General's improper attempt to interject herself into the fee issue in this case is caused by the very structure of the deal the State has insisted upon: a structured payout over four years with considerable future administration costs and duties imposed on both sides. Under the State's desired structure, we will be providing

services to our clients for four years. Given the fact that the Department now freely concedes it allowed public records to degrade, which will require restoration, there will understandably be issues and disputes that will arise. Thus, the reason we cannot allow the Attorney General to interfere with our fees is simple: The Attorney General, counsel for our clients' adversary for 12 years, would have the power to cut off our future funding, whether the State exercises the power or not. The appearance this creates for the class is that we have compromised our clients' interests in order to avoid a fee dispute. For example, if we were to object to anything the State does between now and the date the final award of fees is made, the Attorney General can punish us by appealing our fees. The class members will undoubtedly conclude that we have compromised our obligation to provide zealous representation in order to obtain a monetary benefit.

Again, in case you believe we are being overly cautious, we invite you to review the record in the *Kerr* case. When that case was initially filed, the Department estimated the total refunds would exceed $28,000,000. When we finally got to the hearing on attorneys' fees, the Department estimated the refunds would be $16,000,000. But, when we received the final accounting from the Department, showing the actual refunds paid, the amount was under $12,000,000. Numerous discrepancies were discovered. For example, people got refunds for some but not all tax years even though they were federal employees for all years at issue. The *Kerr* record includes the representative situation involving a former Assistant United States Attorney who had previously handled tax matters for the Internal Revenue Service. She had prepared both her and her husband's claim form and mailed them in the same envelope to the Department. The Department acknowledged her claim but denied ever receiving a claim from her husband. Internal Revenue Service agents who were closely following the *Kerr* case told us of other discrepancies and irregularities.

The statistical anomalies we discovered are set forth in a motion we filed in the *Kerr* case. Of course, when we filed that Motion, we did not know the Department had allowed relevant public records to degrade, and the Attorney General never disclosed this fact to the taxpayers, the Court or the public. Many of the records that are relevant to this case are also relevant in the *Kerr* case, and we do not yet know the degree to which the degraded data affected the *Kerr* refund calculations. That, of course, is an issue for another day and another court, but it highlights the fact that it is logical to assume there will be disputes between the class members and the Department concerning the refund process, whether innocent or intentional.

After spending time with various Department personnel, we must tell you we like them. We do not believe they would intentionally seek to frustrate the refund process. Needless to say, others may not share our same comfort level, but, regardless, disputes will arise given the combination of human beings utilizing degraded data, and we will play an active role in resolving those disputes.

Our concerns with the appearance of the Attorney General's position are well-founded based upon our prior experience in both this case and the federal retiree case. As you may know, the State requested (and obtained) sanctions against us twice (both of which awards required us to expend substantial effort to reverse) simply because the Attorney General did not care for our legal theories — theories which subsequent United States Supreme Court decisions validated and which lead to refunds of illegal taxes to thousands of Arizona taxpayers. Given this history, class members will ask why would we ever agree to give the Attorney General the power to control our fees unless there was some other consideration present? If we were to do so, the class members will undoubtedly conclude an agreement exists whereby if we are good boys, and we remain compliant and acquiescent, we get our fees. If, however, we dispute the State's calculation of the refunds, or its asserted administrative costs, or the determination of the taxability of the administrative costs, or any other issue, the Attorney General will appeal our fees and we do not get paid until the appeal has concluded. Whether this is the Attorney General's actual intention or not is ultimately irrelevant; the Attorney General's request violates the ethical rules we are obligated to follow and we will have no part of it. We told you before, and we tell you once again, we cannot ethically agree to such a provision and the Attorney General cannot request it of us. *See, e.g.,* E.R. 2.1.

Finally, in order to make the record absolutely clear, we want to emphasize again the fact that we are not concerned about legitimate challenges to our fees. Nor are we afraid of the State objecting to our fees, as a general matter. Consequently, if protecting the class members from their counsel is truly the Attorney General's overriding concern, we can renegotiate the settlement. If the State is willing to pay all of the class members at once, using a neutral class administrator appointed by the Court to administer the refund process, which will limit our duties to our clients in the future, we agree that the Attorney General can make any objections she wishes — subject to us demonstrating that any such objection is contrary to clearly established law. In fact, the Attorney General can throw any arguments at us she wants to make (within, of course, ethical limits) and we will address them. Although all of the Attorney General's alleged "issues" have already been litigated in our

favor and the State is collaterally estopped to raise them again, we are confident we can overcome them once more if necessary. But, the simple fact of the matter is that the State cannot keep the current settlement structure it has requested and simultaneously allow the Attorney General to control (or even appear to control) our independence as attorneys. That is something we will not agree to; not now or in the future. If you have an alternative settlement structure you would like to propose to resolve this impasse, which complies with the ethical rules that govern all attorneys in this State, including the Attorney General, we remain willing to consider it and will work with you in good faith to conclude it.

In conclusion, given the amount of effort that has been devoted to reaching a win-win settlement, we have grave misgivings concerning what is really going on here. Based on intuition, informed by years of experience in this area, the Attorney General's current position strongly suggests that there is an agenda other than a good faith effort to formally consummate the agreement in principle previously reached. Hopefully we are mistaken. We remain willing to discuss a legitimate settlement that benefits the class members, the State and the citizens of Arizona.

Very truly yours,

Randall D. Wilkins

Randall D. Wilkins
For the Firm

cc: Eugene O. Duffy, Esq.
Paul V. Bonn, Esq.

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File No. 8032-04

July 24, 2002

PRIVILEGED SETTLEMENT COMMUNICATION PROTECTED BY RULE 408, ARIZONA RULES OF EVIDENCE

VIA HAND DELIVERY

COPY

Michael F. Kempner
Chief Counsel
Tax Section Office of the Attorney General
1275 West Washington
Phoenix, Az 85007

Re: *Estate of Helen H. Ladewig v. Arizona Dept. of Revenue*
No. TX97-00075

Dear Mr. Kempner:

We have read, with interest, Bruce Meyerson's article entitled "Preparing for Mediation: Effective Representation of Clients" which he sent us on July 17, 2002, in connection with our upcoming mediation. The very first suggestion raised by Mr. Meyerson in his article is that the parties must share information with each other to facilitate a solution. We are sending this letter to you with Mr. Meyerson's suggestion firmly in mind.

We believe it will both expedite and facilitate the mediation process if the Department has a better understanding of our concerns as to the issue of the "appropriation contingency." Similarly, it would greatly assist us in identifying possible solutions if we had an understanding of the Department's true concerns over attorneys fees and costs. The end sought here is candor so that a true settlement of the matter can be consummated. We assure you that we have no hidden agenda. We expect the Department through reasoned action to

provide us that same candid assurance. As we approach the mediation, it is important for the Department to appreciate that, from our perspective, the mutual trust and candid discourse ended during the late afternoon of May 17, 2002. From that point in time to the present, the Department's approach has changed from one of enthusiastic and creative cooperation to a decidedly hostile adversary. Long gone is the Department's joint pursuit of a win-win settlement to end finally all aspects of this litigation.

Turning to the "appropriation contingency" issue, we acknowledge the Department's concern. Our concern is simply that we have an unambiguous agreement that provides that the class shall receive exactly what the settlement states. Therefore, if the Department is unable to perform timely its obligations under the agreement, for whatever reasons, we want clear provisions setting forth interest, including interest above the cap to compensate for the delay. In addition, we want clear agreement that the Court, as the third branch of government, can enforce the agreement. There is nothing untoward here. These are customary provisions in settlement agreements in cases like these to insure that the settlement relief is not illusory.

In this context, the Department must appreciate, even if it finds it distasteful, that the class includes many sophisticated (including attorneys) members, several of whom were burned, in their view, by the Department in *Kerr II*. In light of the *Kerr II* experience, where less than $12 million out of $28 million owed was paid by the Department, a settlement without a clear judicial enforcement provision will not satisfy the Rule 23 requirement of being fair to the class.

A related aspect of the appropriation contingency issue is to insure the clarity of the agreement's provisions with respect to the identification of the common fund. This is important for two reasons. One, it eliminates the potential for a future dispute if the Department's concern materializes – the Arizona Legislature should fail to appropriate funds. The Court may enforce the agreement from the refund fund. The case law, as established by the Department in *Kerr II*, makes clear that the source of the refunds is the refund fund. The Department has sought the important benefit of an installment structure. However, the substantive remedy does not change simply because there are credit terms in this settlement. The United States Supreme Court's ruling in a tax refund case establishes that neither the Legislature nor the Governor may lawfully change this provision of state law as to this case. *Reich v. Collins*, 513 U.S. 106 (1994).

The other important reason to carefully define the common fund is to maximize the economic value of this settlement structure for the class. Clarity in identifying the common fund insures that the class members will only have to report for tax purposes their true recovery – the net recovery. We recognize that the Department is unwilling to take the lead on this issue. However, one of the benefits of the settlement which offsets the class's obligation to pay the costs of administration is that under our original agreement in principle, it was clear that the class would not have to report for federal tax purposes the gross amount, without reduction for the Department's costs of administration and attorneys' fee and costs.

Turning to the attorneys' fees issue, although the Department and the Attorney General continue to assert a right to object to our attorneys' fees, you will not share with us their actual concerns in that regard. Thus, we can only speculate as to your client's and the Attorney General's motivations. We would appreciate it if you would inform us as to what the actual concerns are. Your letter of July 22, 2002, appears to indicate that they are concerned with the amount of attorneys' fees that may be awarded to us by the Court and paid by our clients. As you know, we believe this is the precise issue litigated in the *Kerr III* case, and our Court of Appeals and Supreme Court rejected the Department's position. In addition, we are perplexed because we have previously told you that we engaged a nationally recognized legal ethics expert to advise us on the appropriate fee in this case, and we will follow his advice. Our legal ethics expert has been cited by Arizona's Appellate Courts and recognized by the Arizona State Bar as a preeminent authority.

The only legal authority you have ever offered us as support for your position that the Department or the Attorney General has standing to challenge the reasonableness of the fees we will seek here, is the Florida Supreme Court's ruling in *Kuhnlein v. Department of Revenue*, 662 So.2d 309 (Fla. 1995). However, as we have previously informed you, the *Kuhnlein* case was a lynch pin of the Department's standing argument in *Kerr III*. Enclosed herewith are the pages from your office's Reply Brief, filed with the Court of Appeals in *Kerr III*, where your office argued the *Kuhnlein* case. As you know, the Arizona Court of Appeals rejected your arguments and declined to follow the analysis set forth in *Kuhnlein*. Our Supreme Court then denied the Department's request to review the Court of Appeals' decision. *Kuhnlein* is simply not valid authority in Arizona.

Also, we believe you have skipped over a critical distinction between the laws of Florida and the laws of Arizona. As you know, the *Kuhnlein* decision is based upon the *parens patriae* doctrine, which is a common law doctrine. Black's Law Dictionary (6th

Edition 1991), which is relied upon by courts and attorneys throughout Arizona, defines *parens patriae* as follows:

> "Parens patriae," literally "parent of the country," refers traditionally to role of state as sovereign and guardian of persons under legal disability, such as juveniles or the insane; . . . It is a concept of standing utilized to protect those quasi-sovereign interests such as health, comfort and welfare of the people, interstate water rights, general economy of the state, etc.
>
> *Parens patriae* originates from the English common law where the King had a royal prerogative to act as guardian to persons with legal disabilities such as infants. (At p. 769)

However, the *parens patriae* doctrine is not recognized in Arizona, and it would be unconstitutional for the Attorney General to advance such an argument given the fact that the Attorney General in Arizona has no common law powers – her powers are strictly defined by those granted in the Arizona Constitution or by the Arizona Legislature in a statute. We respectfully invite your attention to the Arizona Supreme Court's decision in *Shute v. Frohmiller*, 53 Ariz. 483, 90 P.2d 998, 1001 (1939) ("... under constitutions containing provisions similar to those in Arizona, the attorney general is not a common-law officer ..."). However, in Florida, in contrast to Arizona, the office of Attorney General is a common law position, and thus, the Florida Attorney General has common law powers and has the ability to assert common law theories, as explained by the Florida Supreme Court:

> The office of Attorney General has existed both in this country and England for a great while. The office is vested by the common law with a great variety of duties in the administration of the government. It has been asserted that the duties of such an office are so numerous and varied that it has not been the policy of the Legislatures of the states to specifically enumerate them; that a grant to the office of some **powers** by statute does not deprive the **Attorney General** of those belonging to the office under the **common law**. The **Attorney General** has the **power** and it is his duty among the many devolving upon him by the **common law** to prosecute all actions necessary for the protection and defense of the property and revenues of the state; ... (Emphasis in original)

See *State ex rel. Watson v. Dade County Roofing Co., Inc.*, 156 Fla. 260, 22 So.2d 793, 800 (Fla. 1945).

Simply put, neither the Department nor the Attorney General has either the standing or the power to object to our fees, which is a matter between us, the Court and our clients, and we believe it would be a violation of Arizona law for the Attorney General to attempt to do so here. Once again, we ask you what is the authority for your position and what is the lawful concern you are trying to advance by that position?

Although you have also told us, and Judge Katz, indirectly, that you believe our attorneys' fees "should not be part of any settlement agreement ..." and that we are somehow wrong to insist the Department follow the ruling in *Kerr III*, which holds that the Department lacks standing to challenge the reasonableness of our attorneys' fees request,[1] that is not what the Attorney General told the Arizona Court of Appeals in the briefs she filed in the *Kerr III* case. Because you have previously told us you have not looked at the briefs your office filed in that case, and you were not the attorney who wrote those briefs, we will quote your office's brief to you because it directly contradicts the position you are now advancing here to block our settlement:

> **Attorneys contend that their efforts have resulted in a fund from which they should be paid millions of dollars, but that is not the case. "Common funds" generally result from settlement, with a term of the settlement being payment of attorneys' fees from the common fund. *See, e.g., Skelton v. General Motors Corp.*, 860 F.2d 250 (7th Cir. 1988), cert. denied, 110 S.Ct. 53 (1989). In fact, the common fund as a source of attorneys' fees can be an effective settlement tool.**
>
> **In the present case, no such settlement was reached ..." (At p. 20)**

(Emphasis added.) A copy of the quoted page from your office's *Kerr III* brief is attached hereto for your convenience.

[1]This holding is found on page 217 of the Arizona Reports, under heading that is both bolded and in all capital letters, reading: "THE DEPARTMENT DOES NOT HAVE STANDING TO ASSERT THE DUE PROCESS RIGHTS OF THE NON-PARTY TAXPAYERS".

Similarly, the Attorney General argued in the Department's *Kerr III* Reply Brief that a common fund fee award was not justified there because, unlike the situation in this case, the *Kerr* action had not been class certified:

> Attorneys place undue reliance upon cases such as *Bailey v. State*, 500 S.E.2d 54 (N.C. 1998) and *Kuhn v. State*, 294 P.2d 1053 (Colo. 1996) . . . .In both *Bailey* and *Kuhn*, a common fund fee award was approved only after a class was certified and the court ordered the refunds to be paid.
>
> Unlike the cases cited by attorneys that involved certified classes or specific court ordered refunds, the refunds in this case were made without any court involvement. (Reply, at pp. 14, 15)

As we have repeatedly told you, we cannot agree to the settlement structure the State desires (refunds spread out over four years) while the Department and its attorneys simultaneously control our fees, and thereby, our independence. We believe it is the Department's attempt to drive a wedge between us and our clients, the class members, that is actually impermissible here. This very point was made by our Supreme Court in the case of *In the Matter of Fee*, 187 Ariz. 597, 601-602, 898 P.2d 975 (1995), arising out of a medical malpractice action against the State and Pima County, where the Court recognized the conflict that arises when the State uses the tactics the Department is using here, and warned against it:

> We wish to discourage the previously-described tactic of "driving a wedge" between lawyer and client in negotiations. Although nothing in our ethical rules expressly prohibits separate offers of attorney's fees, we agree with the New York City Bar ethics committee that they frequently pose a serious dilemma for lawyers. *New York City Bar Association Committee on Professional Ethics*, formal op. 80-94. Quite simply, such offers are often intended to place attorneys in the uncomfortable position where they may be caught between their own need to be compensated for legal services and what might otherwise be in their clients' best interests. **We therefore urge judges to carefully scrutinize attempts to employ this practice.** (Emphasis added.)

Finally, you represented at the hearing before Judge Katz last week and in your letter of July 2, 2002, that one issue, which we can only surmise is "the attorney fee standing issue," has always been the "thorn in everybody's side from the beginning" in this settlement.

If you are referring to the attorney fee standing dispute, we do not believe that is true, and we would like to know the factual basis if you are making that assertion. We went back and looked at the original letter we sent you on February 13, 2002, setting forth the class's initial settlement offer. A true and correct copy of that letter is also attached hereto for your convenience. Paragraph 4 of that letter, entitled "Attorneys' Fees and Costs," provides as follows:

> The attorneys' fees and costs will be borne by the taxpayer class. *Attorneys' fees and costs of the taxpayer class will be determined by the Court, upon notice and opportunity of the class (only) to be heard on that issue.* The percentage awarded by the Court will be subtracted and paid from each of the installment refund payments when same are paid to class members. (Emphasis added.)

In your letter of March 19, 2002, you responded to our settlement offer and submitted a counter-offer on behalf of the Department. Your letter contains ten separate paragraphs, eight of which are specifically numbered. A true and correct copy of your letter is also attached hereto for your convenience. In paragraph six, entitled "Attorneys' Fees," you state:

> 6. **Attorneys Fees.** Attorneys for the class shall petition the Court for approval of reasonable attorney fees, taxable costs and other expenses, all of which are expenses of the class as outlined above. (Emphasis in original.)

That is all you state on the matter. We have reviewed your letter carefully, and we cannot see anywhere where you raised the issue of either the Department's or the Attorney General's standing to object to our attorneys' fees, even though our settlement proposal specifically provided that *only* the class could be heard on that issue. We would like you to carefully review your letter and tell us where, in your letter, you believe you raised the Department's or the Attorney General's standing to be heard on the attorneys' fees issue. Please identify the paragraph by number. Inasmuch as you have informed Judge Katz that one area of dispute, which we can only surmise is the attorney fee dispute, has been an issue in this settlement from the beginning, we want to know where in your letter you raised it. As you know, the next communication concerning settlement occurred on March 26, 2002, when we sent you an eight page letter asking you to clarify the terms of the Department's counter-offer. You responded to our letter on April 16, 2002. Your letter is five pages long and contains 15 separate paragraphs. We have also reviewed it carefully, and once again, we can

find no reference to an attorneys' fees dispute. Please let us know where in your letter you raised the issue of the Department's standing to challenge our attorneys' fees if you now contend that issue has been in the settlement from the beginning. Which paragraph is it?

In point of fact, neither the Department's nor the Attorney General's alleged standing to contest our attorneys' fees was raised until the conclusion of our May 17, 2002 meeting wherein we all jointly revised the Department's re-draft of the settlement agreement we previously sent you on May 8, 2002. Accordingly, there is no basis upon which you can represent to either the Court or the public that this "issue" has been in this settlement from its inception.

In any event, we remain hopeful that we can resolve these issues and look forward to meeting with the mediator. If you could share your actual concerns with us before the mediation, we believe it would assist the parties in reaching a resolution. Please feel free to contact us if you need additional information.

Very truly yours,

Randall D. Wilkins

Paul V. Bonn
Randall D. Wilkins
Eugene O. Duffy
Class Counsel

cc: Bruce Meyerson, Esq.
Tom Prose, Esq.

In summary, the common fund doctrine is not properly applied to Arizona income tax cases.

B. No Common Fund Is Created By an Administrative Ruling That Is Not Legally Binding With Respect To Any Other Taxpayer.

Attorneys contend that their efforts have resulted in a fund from which they should be paid millions of dollars, but that is not the case. "Common funds" generally result from settlement, with a term of the settlement being payment of attorneys' fees from the common fund. *See, e.g., Skelton v. General Motors Corp.*, 860 F.2d 250 (7th Cir. 1988), *cert. denied,* 110 S.Ct. 53 (1989). In fact, the common fund as a source for attorneys' fees can be an effective settlement tool.

In the present case, no such settlement was reached. Plaintiffs' lawsuit was dismissed for lack of jurisdiction, and their administrative appeal was decided by the Board on the merits. As a result, no "settlement fund" or "fund in court" was created. Because the common fund doctrine requires the existence of a fund, it should not apply in this case.

As the Nebraska Supreme Court has explained, quoting from a Washington decision:

> The common fund must be an immediate fund from which attorney's fees may be awarded at trial. The effect of this may well benefit other nursing homes in the state. However, it did

STATE OF ARIZONA

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June 5, 2002

PRIVILEGED COMMUNICATION, RULE 408
ARIZONA RULES OF EVIDENCE

VIA FASCIMILE
AND ORIGINAL BY MAIL

Randall D. Wilkins
BONN & WILKINS
805 N. 2nd Street
Phoenix, Arizona 85004

Re: Ladewig v. Arizona Department of Revenue

Dear Mr. Wilkins:

We are in receipt of your letters of May 22, 2002 and June 4, 2002.

In your letter of May 22, 2002, you contend that the State is without legal standing to be heard on the issue of the reasonableness of your attorney fees. Because you informed us that the attorney fee issue may be a deal breaker, we carefully considered each of your points and, independently, researched the related issues.

In short, the Arizona case of *Kerr v. Killian*, 197 Ariz. 213 (2000) supports the standing of the Department of Revenue to contest the reasonableness of attorney's fees in the context of a class action common fund. The decision was supported by the court's recognition of the burden on the Department associated with the post-judgment administration of payments in that case. Consistent with that result is the holding in *Boeing v. Van Gemert*, 444 U.S. 472 (1980) in which the defendant had no post-judgment administrative responsibilities and no continuing interest in the common fund, and was, therefore, determined to be without standing to challenge the reasonableness of the fees.

Accordingly, we respectfully disagree with your analysis and cannot allow terms in any settlement that would restrict the ability of the State or the Attorney General to challenge any amount of fees that you may pursue. This is especially true in light of the fact that you will not disclose to us the amount of fees you will be requesting.

This does not mean that the State will necessarily contest the fees, but the State will not waive the right to do so. Certainly, for you to jeopardize the settlement over this issue is inconsistent with your statements that the settlement is in the best interests of the class members. Consistent with the State's right to contest the attorneys fees, the State declines at this time to stipulate to the appointment of Professor Coffee from Columbia University as a special master to make findings on the issue. It will be up to the Tax Court to determine whether a special master is necessary. Additionally, we believe that there are many qualified people in Arizona who could act in that capacity at a much reduced cost to the class members.

In response to your letter of June 4, 2002, The State is firmly committed to working out a fair and reasonable settlement for all concerned. If the attorney fee issue will cause you to break the proposed settlement we need to know immediately. Until we hear otherwise, however, we will continue to work on proposed language. We have refrained from sending you new language piecemeal to avoid inefficiencies and in an effort to make the proposed agreement cohesive. The refund process, caps and reserves, and costs of administration must be clearly workable by the State and be clearly understandable by the class members.

Additionally, we have had to wait for a determination as to whether A.R.S. § 35-196.03 applies to the refunds. We have been advised that an appropriation is not necessary for refunds. However, an appropriation and an authorization are both necessary before public funds can be expended for costs of administration, even if that expenditure comes out of what would otherwise be refunded to class members. This must be understood in any settlement proposal.

We have heard back from the printer regarding printing notice in a multi-folded form as suggested by Gene Duffy. The printer estimates that it will take three weeks to print; this will necessitate the addition of two weeks to time of mailing.

We are working as quickly as possible to determine necessary and appropriate revisions to the draft documents. The matter is a large undertaking for both the Department and the State whether it settles at this time or not, or whether each individual class member's entitlement is litigated. We trust that you will allow us sufficient time to complete our tasks and that you will not attempt rush us into a hurried review with inadequate time to obtain necessary authorizations and approvals. We have attempted to work with you and schedule status conference dates with the Court in advance. Perhaps the scheduled dates have been too optimistic. However, they were never intended or understood by us to be "drop dead" dates regarding settlement.

Thank you.

Very truly yours,

Michael F. Kempner
Assistant Attorney General
Agency Counsel Division, Tax Section

MFK/plr
#368529 v1 - LT WILKINS/6-5-07

O'Neil, Cannon & Hollman, S.C.
ATTORNEYS AT LAW

July 9, 2002

PRIVILEGED SETTLEMENT COMMUNICATION
PROTECTED BY RULE 408, ARIZONA RULES OF EVIDENCE

VIA FACSIMILE
AND OVERNIGHT MAIL

Mr. Michael F. Kempner
Chief Counsel Tax Section
Office of the Attorney General
1275 West Washington
Phoenix, Arizona 85007

Re: Department's "Draft as of July 1, 2002 @ 6:00 p.m."

Dear Mr. Kempner:

Detailed below are our revisions to the Department's draft revisions to the parties' prior Joint Draft Stipulation of May 20, 2002 ("Joint Draft Stipulation") which you emailed to us after the close of business on July 1, 2002.[1] Where appropriate, we have provided some commentary. We note that there was much more that could have been revised in the Department's draft; however, in preparing these revisions, we were careful to limit our changes to provisions that were either unclear, ambiguous, contrary to our agreement in principle, or assertions of the Department to which the class has never agreed to stipulate. Further, in preparing these revisions, we kept firmly in mind that this is a settlement document and not a situation where the class has been forced to capitulate to a superior hand by the

[1]In as much as our offices (both Bonn & Wilkins and O'Neil, Cannon & Hollman, S.C.) were closed over the four day holiday weekend and we also all worked at home, we did not have an opportunity to review the redline draft which you faxed at 11:24 on Friday, after you had received our letter earlier that week requesting same.

Department. Settlements occur where both sides have something to give and an opportunity to gain. Settlements do not occur where one side or the other seeks an unfair advantage from a settlement in principle, presumably reached in good faith. Therefore, with respect to those aspects of the settlement language where we disagree, we have attempted to make it a fair presentation - *i.e.*, either a statement of each party's position or a statement of the parties' actual disagreed upon positions. We double spaced this letter to facilitate your review and are also emailing you a copy to facilitate revising the Department's current draft stipulation ("Stipulation").

We now turn to a line-by-line analysis of the Stipulation. Rather than try to rewrite the proposal, we have concluded that the appropriate response is to address, by page and line, every issue which requires resolution. To that end, we have printed out a copy of the latest draft of the Stipulation and attached it so that there can be no confusion as to the portions of the Stipulation to which we refer.

1. Page 2, lines 10-13. The sentence beginning with "Further" should be deleted because it is false. The Arizona Supreme Court unequivocally ruled on the class certification issue, which was an issue specifically raised by the Department as one of the issues in the Special Action. Perhaps this insertion is simply an oversight due to the change in personnel assigned to this case. However, because we think the fact of the Court's ruling is indisputable and we

do not think it worthwhile to further contest this point at this time, we are willing to have the sentence revised to read as follows: "Further, it is the Department's contention, a contention with which Plaintiffs disagree, that the Defendants have never exhausted [return to original text]." Otherwise, the sentence in your draft must be deleted.

2. Page 3, line 2. Add the following at the end of the phrase "to pay refunds": "as to those individuals who opt out."

3. Page 3, line 11. The period after the word "hereto" should be moved to follow the phrase "("Amended Plan of Notice")".

4. Page 3, line 13. The heading of Paragraph 3 should be revised to read as follows: "Necessity of Claim Form For Class Members Not Appearing in Department' s Records." This change provides clarity since you deleted the explanation in the Joint Draft Stipulation as to why some class members are required to file a claim form.

5. Page 3, line 14. Immediately following the phrase "Amended Plan of Notice", the phrase "and this Stipulation" should be added to make it clear that the notice is also pursuant to the Stipulation.

6. Page 4, line 24. The first sentence should be revised to read as follows: "The Common Fund is the total amount of all tax refunds, including interest, due to all members of the class, calculated in accordance with this Stipulation and paid from the monies deposited in the tax refund account or similar account under A.R.S. §§ 42-1116(B) and 42-1117 or their successor provisions."

7. Page 4, line 25. In order to eliminate ambiguity over the power of the court to order compliance with the Stipulation should any event of non-payment occur, the following phrase shall be added at the beginning of the sentence: "Except as may be provided hereinafter,".

8. Paragraph 5.A., as contained in the Department's current draft is inconsistent with the provisions which were set forth in the Joint Draft Stipulation we sent you on May 20, 2002, provisions which the parties discussed at length and approved. The original language of the Joint Draft Stipulation must be restored because the language in your current version does not work and does not reflect the agreement of the parties. Thirty-five million dollars does not automatically equate with 10% of the Common Fund. At our joint drafting session on May 17, 2002, Mr. Shiffrin was in full agreement with the language of the Joint Draft Stipulation. Please discuss this with Mr. Shiffrin.

9. Page 5, line 17. The phrase "Attorney Fees and Costs" should be "Attorneys' Fees and Costs".

10. Page 5, line 22, the word "reasonably" shall be inserted before the phrase "estimated by the Department".

11. Page 6, line 3. The word "no" should be changed to "any". The Department has sufficient time (four years) before the final payment to resolve all opt-out refunds. The class is not going to assume risk of loss for the Department's delay.

12. Page 6, lines 12-14. Delete the final sentence of the paragraph for the same reason as set forth in the immediately preceding numbered paragraph.

13. Page 6, lines 20-22. The first sentence of Paragraph 6.D. must be revised. The phrase "In connection with each installment payment," should be added to the beginning of the sentence to remove ambiguity.

14. Page 7, lines 9-10. The phrase "that it believes are" must be removed to avoid potential ambiguity. The refunds are to be computed in accordance with the Stipulation, not the Department's "belief".

15. Page 7, line 13. The heading for Paragraph 7.A. should read "State and Federal Records Available to Department".

16. Page 8, line 6. To remove ambiguity as to the Department's obligation to attempt to restore degraded public records, the phrase "and determine whether to seek professional services to digitize" should be replaced with "and shall seek professional services if necessary to digitize".

17. Page 8, line 9. To clarify the obligation of the Department and its consultants, to the end of existing Paragraph 7.A. shall be added the following: "Within 90 days of commencing to provide data recovery or digitization services (and no later than 120 days from the date of this Stipulation), and each 90 days thereafter, the Department shall file with the Court and serve upon Class Counsel a status report regarding the services. If it appears to Class Counsel from the report or otherwise that the progress of the services is unsatisfactory, Class Counsel may petition the Court under Paragraph 2__ for appropriate relief." Note that the reference to Paragraph 2__ is to former Paragraph 27, which will have to be renumbered due to required changes.

18. Page 8, line 10. This section of your draft is confusing. In order to clarify which records we are talking about, immediately before current Paragraph

7.B., the two sentences of text now appearing at page 9, lines 13 to 21 which begin "If the tax return records" and ends "of such dispute." shall be moved and become a new Paragraph 7.B. which shall have the heading "Taxpayer Records." In addition, to the first sentence of the text moved from Page 9 the phrase "(including all data described in or recovered under Paragraph 7.A.)" shall be inserted after the phrase "in the Department's possession" now appearing on page 9, line 13. In addition, the word "member" now appearing at page 9, line 17 needs to be changed to "member's". The new Paragraph 7.B. should read as follows:

> 7.B. Taxpayer Records. If the tax return records in the Department's possession do not contain all of the necessary data (including all data described in or recovered under Paragraph 7.A.), the Department will request copies of the necessary returns or data from the class member ("Taxpayer Records"). The request will be mailed to the class member by first class mail at the member's most recent mailing address as reflected in the Department's records. If there is a dispute pursuant to Paragraph 8 concerning the class member's Arizona taxable income or Arizona income tax paid for the years 1986 through 1989, the Department shall use the amount agreed to by the affected class member and the Department or, if the class member and the Department fail to agree, an amount approved by the Court in resolution of such dispute.

19. Old Paragraph 7.B. shall be renumbered as 7.C.

20. Page 8, line 15. Insert the word "insufficient" before the phrase "electronic record" to clarify the intent.

21. Page 8, line 23. Add the following explanatory language at the end of now-renumbered Paragraph 7.C.: "The parties believe that the use of the 49.28% factor to determine the refund amount closely approximates the refund amount that would be derived for the class if all of the related adjustments and calculations otherwise required to be made to determine the refund had, in fact, been made."

22. Page 9, line 2. Change the word "or" to "of".

23. Page 9, lines 8-9. To remove potential ambiguity several changes need to be made to the first two sentences. Insert the following phrase at the end of the first sentence of now-renumbered Paragraph 7.E. (former 7.D.), which ends on line 8: "to arrive at an "Adjusted Taxable Income"". In the second sentence, which begins on line 8, replace the phrase "resulting amount" with "Adjusted Taxable Income" and add the following to the end of that sentence: "by applying the tax rates in effect for the applicable year to the Adjusted Taxable Income".

24. Page 10, line 2. The phrase ", address correction requested," shall be inserted before the word "sent".

25. Page 10, lines 7-12. To remove potential ambiguity and to clarify the parties' agreement, the sentence which begins on line 7 should be rewritten in its entirety to provide as follows: "If the Department has previously requested documents or other data from a class member for any particular tax year pursuant to Paragraph 7.A. above, and if such class member or authorized representative fails to provide those documents for the particular tax year to which the request relates within 45 days from the date the Department mails the request, the Department may enter a dollar amount equal to the greater of (i) $0.00 or (ii) the amount reflected in the Department's records, for such item in the Notice of Dividend Calculation for which the Department requested and did not receive information for such tax year."

26. Immediately following the sentence which is described in the preceding comment, the following sentence shall be added: "Any request by the Department for documents or data shall notify the class member of the foregoing 45 day time limit and the effect of failure to timely respond."

27. Page 10, line 12. The sentence which presently begins on line 12 should start a new paragraph in Paragraph 8 and after the phrase "A class member shall" in that sentence, the word "also" shall be inserted.

28. Page 10, line 24. The sentence beginning "The Notice. . ." should be the start of a new paragraph in Paragraph 8.

29. Page 10, line 27 to page 11, line 5. The text of the sentence beginning on page 10, line 27 shall have the introductory phrase beginning with "If the Common Fund" and ending with "Paragraph 6C," deleted and the following phrase added to the end of that same sentence: "in proportion to their refunds for all years". The last sentence of Paragraph 8 shall be deleted.

30. Page 11, line 6. To minimize the potential for political mischief and to reflect our agreement, add the following as the first sentence of Paragraph 9: "Refund payments are to be made from monies available for tax refunds, which monies are presently described in A.R.S. §§ 42-1116(B) and 42-1117."

31. Page 11, line 27 to Page 12, line 2. The first sentence of Paragraph 11 shall be replaced with the following: "The Costs of Administration shall be paid out of the reserve for Costs of Administration set forth in Paragraph 5.A." This

is important to the class since it may adversely affect their reporting position as addressed in paragraph 19 of the Stipulation and accurately reflects who is actually paying the Costs of Administration.

32. Page 12, lines 3-4. To remove the potential for ambiguity and reflect the discussions on this subject which we had last May, after the phrase "shall include" on line 3, delete the phrase ", but not be limited to," and insert the following: "the ordinary and necessary costs incurred in the administration of this Stipulation. For purposes of this Stipulation, it is agreed that the term "ordinary and necessary costs" shall be made with reference to the federal cases which construe the term "ordinary and necessary" under Section 162 of the Internal Revenue Code. Examples of costs which shall be deemed 'ordinary and necessary' shall include:". Subpart (1) must be deleted and the remaining subparts renumbered because either we will have a combined notice covered by your current Subpart (2) or the Department will have to comply with the Supreme Court's notice order.

33. Page 12, lines 10-11. Subpart (8) and the word "and" which precedes it shall be deleted as it is subsumed within the definition and matters described immediately above and, therefore, is unnecessary.

34. Page 12, line 11. The phrases "The above costs shall include, but not be limited to" shall be deleted from sentence which begins on line 11 and the following phrase substituted in its place: "Costs of Administration shall also include". This makes the sentence consistent with what has gone before.

35. Page 12, lines 17-19. The sentence beginning on line 17 shall be deleted and replaced with the following: "The Costs of Administration shall include only costs incurred by the Department on or after the date this Stipulation is submitted for Court approval, which date shall be deemed to be July 1, 2002 if the submission occurs on or before July 22, 2002 and only to the extent such costs are approved by the Court as described below. The Department may submit requests for Court approval in advance of incurring costs, subject only to the Department's obligation to account for such costs."

36. Page 12, line 19. The following shall be added to the end of the paragraph: "Costs of Administration shall not include costs incurred with respect to persons who opt out of the class or additional costs incurred by the Department due to any failure to timely pay any refunds provided hereunder for any reason whatsoever."

37. Page 12, line 21. Insert the word "only" between "Administration" and "upon".

38. Page 12, line 24. Insert "obtain Court approval to" before "set funds. . ."

39. Page 12 lines 26-27. Immediately following the phrase "Costs of Administration" on line 26, insert the phrase ", including any costs disallowed by the Court," and delete the phrase "and attorneys' fees and costs" on lines 26-27 as the latter has nothing to do with Costs of Administration described in Paragraph 11.

40. The provisions of paragraph 14 in the Department's draft are not an accurate presentation of the parties' positions. In addition, the language proposed by the Department does not track the operation of the agreement reflecting how the reserves are adjusted during the term of the Stipulation. It also appears that the provision that the Department would be bound by the Court's ruling and would not be permitted to appeal was inadvertently omitted from your draft. As we have previously pointed out, this provision is essential to cure both the constitutional and ethical flaws inherent in the Department's contentions under the facts and circumstances of this case, and to preserve the settlement structure - payments over 4 years - that the Department has requested. In this respect,

we point out that we have recently participated in a national class action summit sponsored by the leadership of the national defense class action bar. Our position and that of our experts concerning the Department's position on this issue was unanimously reconfirmed by a distinguished panel of nationally recognized defense class action lawyers. Their consensus view was that a position such as that contended for by the Department was inappropriate, unlawful and offensive.

Finally, we have also revised the provision for initial payments of Attorneys' Fees and Costs. Having had the opportunity to review with experts from the nation's leading class action settlement administration firms, it is apparent to us that given the size and composition of this anticipated settlement class, the costs and demands placed upon us will be significantly greater than initially projected, and the amount will have to be adjusted.

Consequently, Paragraph 14 in your current draft should be deleted in its entirety and the following substituted therefor:

"Class counsel shall file a motion with the Court for an award of reasonable attorneys' fees and costs under the common fund doctrine. The motion shall include all claims for attorneys' fees and costs, including but not limited to, class counsel's claims for

past services and class counsel's claims for the continuing services which will be provided on behalf of the class in connection with the administration of the settlement process until the Department has fully performed all of its obligations under this Stipulation. Class counsel's motion shall be filed with the Court upon the submission by the parties of this Stipulation for approval by the Court. The class shall be provided with notice and be afforded an opportunity to be heard on class counsel's motion in the manner set forth in the amended plan of notice, subject only to modification by the Court. The percentage amount awarded by the Court as fees and costs ('Attorneys' Fees and Costs") shall be paid out of the Common Fund from the Reserve for Attorneys' Fees and Costs described in Paragraph 5.A.

The Department asserts that it has standing to be heard on the question of the reasonableness of attorney's fees and costs to be awarded from the Common Fund, even though the Department has indicated it has not yet determined whether or not it will contest the reasonableness of the attorney's fees and costs sought

by class counsel. Class counsel has informed the Department that it is their view that the Department's assertion is contrary to settled law and, under the facts and circumstances of this case, is barred for several independent legal and ethical reasons.

Irrespective of the Court's decision on the class counsel's motion, the Department will be bound in this case by that decision and shall have neither a right to appeal nor a right to be heard in any appeal of any issue under this Stipulation concerning in any way the Attorneys' Fees and Costs.

Subject to the adjustment for the $2 million in payments described below, the amount awarded by the Court to class counsel as Attorneys' Fees and Costs shall be paid in approximately equal installments at the same time that the installment refund payments are paid to class members pursuant to the schedule set forth in paragraph 9. If the Stipulation is finally approved, class counsel shall be paid the sum of $1 million on December 1, 2002 and $1 million on July 7, 2003. These total payments of $2 million shall be credited against the amount due class counsel for its first installment payment."

41. Page 14, line 23. The following shall be added immediately after the phrase "since the last report": "and shall include a breakdown by category of all Costs of Administration".

42. Page 14, line 24. The following shall be added immediately after the phrase "Unclaimed Property Fund": "including the total number of installment refund payments returned as undeliverable and the number of unsuccessful searches of available address data bases that were undertaken before an undelivered refund check was deposited in the Unclaimed Property Fund,".

43. Page 15, lines 4-9. The sentence on line 4 which begins with the sentence "Class counsel shall be" and the sentence on line 6 which starts "Notice to the Department" are to be deleted in their entirety. The rules of civil procedure dictate who has to give notice and how to give notice. The Stipulation should not change those rules, which are universally recognized as providing due process to all interested persons.

44. Page 16, lines 9-10. The phrase "provided that a notice of appearance is served and filed as hereinafter provided" is to be deleted. It is redundant and inaccurate in relation to what immediately precedes it in the Stipulation.

45. Page 16, line 23. The word "Attorney's" should be replaced by the phrase "Attorneys' Fees and Costs".

46. Page 16, line 27. To the end of Paragraph 19 the following shall be added as the last sentence of Paragraph 19: "If the Internal Revenue Service issues a determination adverse to the class, the Department shall immediately notify class counsel and the class shall have the right to challenge such determination and seek reversal thereof."

47. The Department deleted the undertaking in former Paragraph 20 of the Joint Draft Stipulation which provided for the parties to use their best efforts in connection with getting the Stipulation approved. We assume that the deletion was due to clerical error or inadvertence and the Paragraph should be restored. Obviously, the citizens of this State will expect all of us to use our best efforts to obtain approval. In that regard, we also believe that the following should be added to that Paragraph: "Class counsel and the Department and its counsel shall at all times act in good faith and shall cooperate in implementing this Stipulation."

48. Page 17, lines 13-18. Paragraph 23 should be changed, as follows, in its entirety to accurately state the law that applies to each party and their positions:

"This Stipulation shall be governed by and construed in accordance with the constitutions and laws of Arizona and the United States of America. The plaintiff class acknowledges that it is the Department's position (a position with which the class disagrees) that the ability of the Department to process this settlement is contingent upon the appropriation of sufficient funding and authorization by the Legislature for the Department to incur and pay Costs of Administration. The Department acknowledges that it is the position of the plaintiff class (a position with which the Department disagrees) that the 14th Amendment to the United States Constitution provides a direct remedy in the event that state laws do not provide a clear and certain remedy."

49. Paragraph 24. As you recall, early on in this process the Department requested that we agree to a provision to preclude a "bad mouthing" of the Department and the State in this litigation. We readily agreed to that provision and included language in the initial drafts for that purpose which made it mutual. We believe it would be helpful to put back this provision into the agreement. We note that the provision as drafted is even handed and applies as much to us as it does to the Department. The following should be added to the end of Paragraph 24:

"In furtherance of that end, no party will assert in any forum, press release or a public statement that the litigation or any part of it was brought, prosecuted or defended in bad faith or without a reasonable basis, or otherwise. No press release or other

public statement to that effect shall be made by any party or any parties' counsel, except as may be agreed to by the parties hereto."

50. The Department deleted the provisions set forth in former Paragraph 25 of the Joint Draft Stipulation. The provisions were discussed and approved in the May meeting with the Department. We assume that the deletion was due to clerical error or inadvertence. However, the parallel provision requested by Mr. Shiffrin regarding federal adjustments was retained in your current draft. The Paragraph must be restored.

51. Page 18, line 16-21. Paragraph 28 on Late Payment needs more clarification as the issue of potential non-payment (i.e., breach of the Stipulation) presents a material problem which we have not discussed in depth previously due to our continuing belief that the Department's concern about legislative spending authorization is not applicable to performance under this Stipulation and your assurances that this would not be a problem. However, in view of the Department's position in its current draft, Paragraph 28 should be revised in its entirety to provide as follows: "In the event that refunds are not timely made under the terms of this Stipulation for any reason, including but not limited to the failure of the Legislature to appropriate or otherwise authorize sufficient

spending for Costs of Administration or any legislative change to A.R.S. §§ 42-1116 or 42-1117 which impair refund payment performance hereunder, additional interest shall accrue on the sums not timely paid from the date set for such payment until such payment is made. Such additional interest shall be paid without regard to any limitations that would otherwise be imposed by the application of the Cap and shall be considered an addition to the Cap. In the event of any failure to timely pay, the class may seek and obtain further relief under Paragraph ____." ("Paragraph 2___" refers to former Paragraph 27).

52. Various Pages. The dates agreed upon at our meeting of May 17, 2002 and set forth in the Joint Draft Stipulation for the issuance of the Notice of Dividend Calculation and Refund Payments must be restored.

If the Department's current draft is revised to include the above provisions, we are prepared to sign the Stipulation and present it immediately to the Court for approval, together with the revised plan of notice that we previously submitted to you 8 weeks ago. Please advise and we will make the minor revisions necessary to the draft revised plan notice so that exhibit can be finalized for simultaneous submission to the Court without further delay.

Time is of the essence. As you can see, we have made an extraordinary effort to painstakingly review your draft and turn our comments around over the course of the holiday

weekend because this Stipulation is important to our clients and all citizens of the State. Since the Department has now had 8 additional weeks to exhaustively consider all of the issues that it perceives to be implicated by the Stipulation - a Stipulation whose terms are based upon the Department's previously authorized counter-offer and the Department's own early May redraft of the Stipulation, which redraft formed the basis for the joint drafting conference on May 17, 2002 - we trust that we can have the Department's immediate turn around on these straight forward revisions in the form of a redline Stipulation for final proofing.

If you should have any questions with respect to the above, I will be here the balance of the day and at Randy's office tomorrow.

Very truly yours,

Eugene O. Duffy

EOD/bab

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DRAFT AS OF July 1, 2002 @ 6:00 P.M.

IN THE SUPERIOR COURT OF THE STATE OF ARIZONA

IN AND FOR THE COUNTY OF MARICOPA

ESTATE OF HELEN H. LADEWIG, on behalf of itself and the class of all persons in the State of Arizona who, during any one of the years 1986 to 1989 paid income taxes to the State of Arizona on dividends paid by corporations whose principal business was not attributable to Arizona, et al.,

Plaintiffs

vs.

ARIZONA DEPARTMENT OF REVENUE and its Director, in his official capacity,

Defendants.

No. TX 97-00075

STIPULATION OF SETTLEMENT

(Assigned to the Honorable Paul A. Katz)

BONN & WILKINS, HARTERED 805 North econd Street hoenix, AZ

The above-captioned action was brought by the Estate of Helen Ladewig on behalf of itself and all other similarly situated taxpayers seeking refunds of the taxes imposed upon dividends paid by non-Arizona corporations for the years 1986 through 1989.

On December 4, 1998, Judge Dougherty certified a class consisting of all present and former residents of the State of Arizona who paid Arizona income taxes on dividends paid by corporations whose principal business was not attributable to Arizona during any one

or more of the years 1986 to and including 1989, together with their survivors, spouses, heirs, successors, estates and personal representatives and who for any one or more of the tax years 1986 to and including 1989 have not been paid a refund of all such taxes paid. ("Plaintiff Class") In 1999, the trial court found that A.R.S. § 43-1052 violated the Commerce Clause by allowing deductions from Arizona state income tax of dividends paid by corporations doing 50% or more of their business in Arizona, but not allowing deductions for corporate dividends from corporations doing less than 50% of their business in Arizona. However, disputed issues remain, including, but not limited to, the process by which refunds shall be proven and the amount of refunds due to individual taxpayers determined. Further, the Defendants have never exhausted their appellate rights on certain issues including, but not limited to, their objections to the class under Rule 23 of the Arizona Rules of Civil Procedure. In an effort to resolve these disputes, accelerate the refund process, obviate the potential necessity of requiring taxpayers to prove entitlement, save further expense, avoid the uncertainties of further litigation, and to secure a total and final settlement of the claims by the Plaintiff class against Defendants, the parties desire to settle, compromise, and terminate this action and all claims asserted therein, as well as any and all other claims against the Defendants which might be based upon or arise from any of the matters alleged in this action for years 1986 through 1989, regardless of the legal theory on which such claims for remedies may be based, subject to approval of the Court, upon the terms and conditions contained in this Stipulation of Settlement (the "Stipulation").

Now, therefore, for the reasons set forth herein,

IT IS HEREBY STIPULATED AND AGREED, by and between the parties hereto, subject to the approval of the Court and upon notice and an opportunity for all class members to be heard as follows:

1. NO ADMISSION OF LIABILITY. The settlement of this matter as provided herein shall not be taken or construed as an admission of liability or responsibility by or on

the part of the Defendants ("Department") in this litigation to pay refunds. With respect to those members of the Plaintiff Class who exercise the right to opt-out, the Department expressly reserves the right to contest any and all claims asserted, or to be asserted, by any such person and to assert any and all defenses or procedural requirements that may be applicable. No statement or agreement herein or in connection with this Stipulation shall be admissible against either party except to enforce the Stipulation and the orders of the Court contemplated hereby.

2. NOTICE. The parties agree to amend the forms of notice previously approved by the Court and stipulate to a revised order for notice as set forth in Exhibit "A" hereto. ("Amended Plan of Notice") The stipulation for the revised order for notice will be filed with the Court simultaneously with this Stipulation.

3. NECESSITY OF CLAIM FORM. Persons who are not sent the individual notice pursuant to the Amended Plan of Notice and who believe they are entitled to the stipulated refund relief provided for herein for one or more of the tax years in issue, shall have until **DATE**, to complete and file a written notice and proof of membership in the class with the Department on a form published by the Department for that purpose. ("Claim Form") The Claim Form may be obtained from the Department in person at any Department office, or by written or telephonic request at P.O. Box 29099, Phoenix, Arizona 85038-9099, 602-542-0700. In addition, a copy of the Claim Form may be downloaded from the Department's Internet website, www.revenue.state.az.us. Copies may also be obtained from Class Counsel at Dividend Refund Class Action, P.O. Box 1328, Phoenix, Arizona 85001-1328; Telephone: (602) 734-0834; www.dividendrefundsclassaction.com or www.dividendrefundclassaction.com. A person who under this paragraph is required to file the Department's Claim Form and who fails to file such a form on or before **Date**, will not participate in the stipulated refunds provided for herein. Proof of filing shall be by postmark if mailed or by date of receipt if hand-delivered. The Department will provide to

class counsel a copy of the form and related instructions no later than **July 15, 2002** for class counsel's review and input. Class counsel shall provide comments back to the Department no later than **July 22, 2002.** The form and related instructions will be posted on the Department's website and shall be available from the Department on or after **September 13, 2002.**

4. **OTHER PUBLICITY**. In addition to the formal notice set forth in Paragraph 2, the Department shall actively notify tax and professional trade journals and tax services by formal news release. The formal news release shall include a summary of the settlement, the availability of the copies of the Court approved formal notice, this Stipulation and Claim Form on the Department's website and a contact address and phone number for Class Counsel and the Department to obtain additional information. The Department's formal news release shall be distributed to the Arizona State Bar Association (including the Arizona Attorney publication), the American Bar Association (including the ABA Journal and the Chair of the ABA's Section of State and Local Taxation), the Arizona Society of Certified Public Accountants, the American Institute of Certified Public Accountants, the Bureau of National Affairs, Inc. (Tax Management), CCH Publishers, West Publishing, Warren, Gorham & Lamont, Tax Analysts (State Tax Notes) and Thomson/RIA. In addition, the terms of the settlement and all related documents shall be prominently posted on the Department's website no later than **NEW DATE 2002.** The Department's website shall be timely updated to reflect developments in the approval process and the refund payment process.

5. **COMMON FUND**. The Common Fund is the total amount of tax refunds and interest due to all members of the class calculated in accordance with this Stipulation. The Department shall not be required to deposit into Court or otherwise physically segregate the funds required to satisfy its obligations provided for herein.

A. ***Reserves for Fees and Costs.*** All Costs of Administration, as described in Paragraph 11, and Attorney Fees and Costs, as described in Paragraph 14 shall be borne solely by the class members and shall reduce their refunds on a pro rata basis. A reserve equal to $35 million shall be set aside from the refunds paid to the class members to cover the Costs of Administration of this settlement as set forth in Paragraph 11 below. An additional reserve equal to the total amount of Attorneys' Fees and Costs requested by Class Counsel shall be set aside from the refunds paid to the class members to cover Attorneys' Fees and Costs as set forth in Paragraph 14 below. The foregoing reserves shall reduce refunds on a pro rata basis. Any amounts reserved in excess of the amount approved by the Court for Costs of Administration or awarded by the Court for Attorneys' Fees and Costs shall be paid pro rata to the class members in the final refund installment based on their total computed refunds for all years. The foregoing reserves will be recalculated as of each installment payment date as necessary.

6. **COMMON FUND CAP.** Notwithstanding the amount of the Common Fund computed pursuant to Paragraph 5, the Department's Common Fund payment obligation including distributions for Costs of Administration and Attorney Fees and Costs shall not exceed $350 Million (the "Cap"), subject to the following adjustments.

A. ***Opt-Out Reserve.*** The Cap shall be reduced by the amount of refunds claimed due by members of the class who opt-out within the time established by the Court ("Opt-Out Reserve.") The amount of refunds in the Opt-Out Reserve shall be the amount claimed by the taxpayer (class member?) or estimated by the Department at its discretion in accordance with Title 42, Arizona Revised Statutes, including relevant adjustments and interest calculated or estimated by the Department. All amounts reserved under this provision which are not paid out shall be restored to the Cap and, if the Opt-Out Reserve had previously reduced refunds due to the Cap having been exceeded, refunds shall be adjusted in the same manner as provided in Paragraph 6D. If the refund amount due to an individual who opts out of the

class is not finally determined at least 60 days prior to the mailing of the final installment pursuant to Paragraph 9, no amount reserved for such claim will be restored to the Cap.

B. ***Disputed Dividend Reserve.*** The Cap shall be further reduced by the additional amount of refunds claimed to be due by members of the class who dispute any amount set forth in the Notice of Refund Calculation described in Paragraph 8 over the amount of the Department's calculations using the information contained in such notice ("Disputed Dividend Reserve.")

All amounts reserved under this provision remaining after the resolution of disputes shall be restored to the Cap and, if the Disputed Dividend Reserve had previously reduced refunds due to the Cap having been exceeded, refunds shall be adjusted in the same manner as provided in Paragraph 6D. If there are disputes still unresolved by the time the last payment must be calculated, such amounts reserved will not be distributed to Class Members.

C. ***Common Fund Adjustments.*** In the event that the Common Fund exceeds the Cap as reduced (including as a result of subsections 6A and 6B above), the refunds due to each class member shall be reduced on a pro rata basis so that the Common Fund equals the reduced Cap. Any such reduction shall apply first to refunds of interest and then to refunds of tax.

D. ***Interest Estimates and Adjustments.*** The Department will calculate an estimate of the total interest anticipated to accrue on future installments as of each installment payment date. This estimate will be used to determine the applicability of the Cap in order for the Department to allocate any pro rata reductions to individual refund amounts. In the event a pro rata reduction is applied to any installment as a result of such estimates and it is ultimately determined that the actual interest due is less than the estimated interest such that the total refunds using the actual interest would not have exceeded the Cap (or exceeded it by a lesser amount), the Department shall readjust the previously paid

refunds to the actual amount that would have been paid subject to the overall limitation of the Cap.

Any adjustment made to refunds to class members under this Stipulation shall be made on a pro rata basis. Any refund reduction shall be applied to interest and then to tax. In no event shall the refund to any class member, before reduction for their pro rata obligation for Attorney Fees and Cost and Costs of Administration, be more than the tax refund due pursuant to Paragraph 7D together with applicable interest thereon.

7. **REFUND PROCESS**. The Department shall calculate the refunds that it believes are due pursuant to the terms of this Stipulation for all class members who appear in the Department's records and for all those class members who do not appear in the Department's records but who satisfy the requirements of Paragraph 3 above.

A. ***Available State and Federal Records.*** The IRS sends the Department an Individual Return Transaction File ("IRTF") tape. The IRTF tape contains information that the IRS keys into its system from income tax returns, but does not include copies of the actual returns. The tape includes returns filed from an Arizona address, but not necessarily all Arizona residents. The IRS also sends IMF and 1099-DIV electronic tapes to the Department. The 1099-DIV tapes contain information from some 1099-DIV Forms sent to Arizona addresses. The IMF electronic tapes contain the Individual Master File that contains the taxpayer's name, identifier and address information. To the extent practicable, the Department will use an electronic process to determine the refund due class members hereunder. To that end, the Department will employ consultants to attempt full recovery of all necessary data from those unreadable portions of the Internal Revenue Service's IMF and IRTF computer tapes for the taxable years 1987 through 1989. If this data recovery is unsuccessful, the Department may, in its discretion, seek professional services to digitize the relevant portions of the microfiche of the IMF and IRTF tapes ("Federal Yearbook") for the taxable year 1987 through 1989. The Department will seek professional services to digitize

the relevant portions of the Federal Yearbook for the taxable year 1986. The Department will also seek professional services to digitize the relevant portions of the 1988 Arizona keyed data ("Arizona Yearbook"). The Department will evaluate the quality and quantity of all electronic data from the Federal Yearbook and State Yearbook for tax years 1986 through 1989 and determine whether to seek professional services to digitize additional relevant data to ensure the Notice of Refund Calculation is issued timely (see Paragraph 8 below). The costs of the foregoing and other data recovery and digitization shall be included in the Costs of Administration.

B. ***Dividend Formula.*** Except as set forth below for part-year residents, the dividend income that qualifies for a refund for each applicable year shall be determined by taking the amount reported as dividends on the class member's federal income tax return ("Reported Dividends") as set forth in (1) the electronic records available to the Department; or (2) if that data is not available, the microfiche records for class members for whom the Department has an electronic record of dividends for that year. If the Department has no record of the Reported Dividends or other relevant data, the Department will request copies of the necessary returns or data from the class member to determine the amount of the dividends reported on the taxpayer's federal income tax return ("Documented Dividends"). If there is a dispute pursuant to Paragraph 8 concerning the Reported Dividends or Documented Dividends, the Department shall use the amount agreed to by the class member and the Department, or approved by the Court, in resolution of such dispute. The Reported Dividends or Documented Dividends shall then be multiplied by 49.28% to determine the "Qualifying Dividend" amount.

C. ***Part Year Residents.*** The Department will identify those persons that the electronic records indicate were part-year residents with dividend income. The Department will calculate a resident apportionment percentage for part year residents by creating a fraction, the numerator of which shall be the amount of income subject to Arizona

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tax, and the denominator or which shall be the amount of federal adjusted gross income, all as reported by the class member on the class member's tax returns for the applicable year(s). The resulting fraction shall be multiplied times the Reported or Documented Dividend, which shall be multiplied by 49.28% to determine the Qualifying Dividend amount.

D. ***Refund Calculation***. The refund due for the relevant years shall be determined by subtracting the amount of the Qualifying Dividend from the class member's previously reported Arizona taxable income. The resulting amount shall be used to recompute the Arizona tax for purposes of determining the amount of any overpayment. Interest, based on the schedule of installment payments set forth in Paragraph 9 below, shall be calculated in accordance with A.R.S. § 42-1123 and shall be added to the tax overpayments to determine the total refund due to each member of the class (the "Refund Amount"). If the tax return records in the Department's possession do not contain all of the necessary data, the Department will request copies of the necessary returns or data from the class member ("Taxpayer Records"). The request will be mailed to the class member by first class mail at the member's most recent mailing address as reflected in the Department's records. If there is a dispute pursuant to Paragraph 8 concerning the class members Arizona taxable income or Arizona income tax paid for the years 1986 through 1989, the Department shall use the amount agreed to by the affected class member and the Department or, if the class member and the Department fail to agree, an amount approved by the Court in resolution of such dispute. The Department reserves the right to adjust for federal changes for the years in issue pursuant to the provisions of A.R.S. §§ 42-1104(B)(5), (B)(6) and 43-327. Subject to this reservation, the Department has agreed to forego the right to audit, assess, setoff or otherwise adjust for additional tax due on the tax return for the year(s) in issue.

8. NOTICE OF DIVIDEND CALCULATION. On or before **a date no more than 15 months after final Court approval of this Stipulation,** the Department shall advise each

class member, by first class mail sent to the member's most recent mailing address as reflected in the Department's records, of the Arizona taxable income previously reported, the Arizona income taxes previously paid, and the Reported or Documented Dividend amount that the Department will be using for the refund formula calculation for each of the years for which a class member may be entitled to a refund under the Stipulation ("Notice of Dividend Calculation.") If the Department has previously requested documents or other data from a class member pursuant to Paragraph 7 above, and if such class member or authorized representative fails to provide those documents within 45 days from the date the Department mails the request, the Department may enter a dollar amount of $0.00 for each item in the Notice of Dividend Calculation for which the Department requested and did not receive information. A class member shall have 45 days from the mailing date of the Department's Notice of Dividend Calculation to file a written objection to the correctness of the Arizona taxable income previously reported, the Arizona income tax previously paid and the Reported or Documented Dividend amount reflected in the Department's Notice. The Department's Notice of Dividend Calculation shall set forth the right to object to the correctness of any amount in the Notice. There shall be no other grounds for objection. If there is no timely objection filed in response to the Department's Notice of Dividend Calculation, the amounts set forth in the Department's Notice shall be final for the calculation of all refunds provided for hereunder for the class member. Class counsel or other authorized representative of the class member shall be contacted if the Department is unable to resolve a dispute directly with the class member. If the class member and the Department cannot agree on the correct amount, the matter shall be determined by the Court pursuant to Paragraph 27 below. The Notice of Dividend Calculation shall also inform class members that the Department will not pay any Refund Amount which totals less than $4.00 for all years in issue, unless requested in writing by the class member no later than 45 days after the mailing date of Notice. If the Common Fund has been reduced pursuant to

Paragraph 6C, the Refund Amounts, if any, which are not paid, as the result of this provision, shall be distributed pro rata to the class members in the final refund installment. In no event, however, shall these pro rata distributions exceed the amount of the reductions pursuant to Paragraph 6C.

9. REFUND PAYMENTS. Payments will be made in four (approximately equal) installments with the first installment payment to be made no later than **a date 19 months after final Court approval of this Stipulation**, the second installment payment to be made no later than **JULY 9, 2004 (may need to be changed)**, the third installment to be made no later than **JULY 10, 2005 (may be changed)**, and the final installment to be made no later than **JULY 14, 2006 (may be changed)**. The initial installment payment shall include a notice of the estimated total Refund Amount to be paid to the class members, without any necessary adjustments as outlined in this Stipulation. Class members will receive upward adjustments if any, with their final installment payment. At the option of the Department, class members whose total refund amount is $400 or less may be paid in one installment on the date set forth above for the first installment payment. In consideration of being paid in a lump sum, such class members shall not participate in the event there are upward adjustments to refund amounts paid with the final installments. The Department may prepay its entire obligation hereunder at anytime recalculating interest to that point in time. The Department will not pay any Refund Amount which totals less than $4.00 for all years in issue, unless requested in writing by the class member as set forth in Paragraph 8 above.

10. OTHER DEBTS. Each payment to a class member under this settlement, after all adjustments and prorations, including reserves, shall first be credited against any amount of tax, penalties or interest due the State of Arizona and then against any other debts or taxes owed to or through the State of Arizona or the federal government according to the standard order of preference used by the Department for other income tax refund offsets.

11. COSTS OF ADMINISTRATION. The Costs of Administration shall be paid by

the State and shall be a charge against the reserve set forth in Paragraph 5A. For purposes of this Stipulation, Costs of Administration shall include, but not be limited to, (1) the costs of preparation and mailing of the initial class notice (2) the costs of preparation and mailing of the class notices provided for hereunder; (3) the costs of any other notices and communications needed to be performed by the Department; (4) the costs of data preparation, capture, recovery, conversion, and analysis; (5) the costs of researching tax records; (6) the costs of refund calculations and payments; (7) the costs of any special masters, mediators, arbitrators whether appointed by the Court or by agreement of the parties; and (8) all other costs necessary for the implementation and administration of this settlement agreement. The above costs shall include, but not be limited to: the direct costs of Department of Revenue personnel including salary and employee related expenses; the costs of contract personnel; the costs of purchasing or leasing equipment; the costs of leasing or renting space; the costs of consumable supplies; the costs of consultants; the costs of services; and the costs of mailing including postage. The Costs of Administration shall not include the costs of the Department's attorney fees or any other costs not necessary to the refund process provided for in this Stipulation or ordered by the Court. The Costs of Administration shall include costs incurred by the Department commencing July 1, 2002 consistent with this paragraph.

The Department may draw upon the reserves set forth in Paragraph 5A for Costs of Administration upon approval of the Court. The Department may petition the Court, or a designee of the Court, for advance approval of expenditures before incurring those costs or may seek Court approval after the Costs are incurred. Prior to the final payment the Department shall estimate its remaining Costs of Administration and set funds aside from the reserve set forth in Paragraph 5A to cover such anticipated Costs. All remaining funds in the reserve in excess of the total expended and anticipated Costs of Administration and attorneys' fees and costs shall be paid on a pro rata basis, in the final refund installment, to

the class members, other than those who have been paid in a single installment as set forth in Paragraph 9. Any such pro rata adjustment shall be based on the class members' total computed refunds for all years.

12. UNDELIVERABLE REFUND PAYMENTS. The Department agrees to utilize the following procedure for any installment refund payment returned as undeliverable. In the event that an installment refund payment is returned as undeliverable, the Department will undertake to search its database and the data available to it both from the Internal Revenue Service and outside contractors who have access to the national database maintained for the Untied States Post Office in order to attempt to obtain a better address of the person who is to receive the returned payment. If, and only if, no such address can be ascertained, will the undelivered refund check be deposited into the Unclaimed Property Fund and administered pursuant to Title 44, Arizona Revised Statutes.

13. DECEDENTS' REFUNDS. In the event that a refund is due to a deceased individual or individuals and the estate(s) for such individuals have been closed, or in the event no estate has ever been opened, the Department shall use the same procedures for Decedents' refunds that are used for unclaimed property under A.R.S. § 44-301, et seq. In the event a dispute arises between the claimant and the Department, the matter may be submitted to the Court under Paragraph 27 hereunder or if the refund amounts become unclaimed property the claimant shall have all remedies available under A.R.S. § 44-318.

14. ATTORNEYS' FEES AND COSTS.

Class Counsel shall file a Motion with the Court for all claims for attorney fees and costs that may be allowed by law. Such Motion shall be filed concurrently with the submission of this Stipulation to the Court. Any amount awarded by the Court as attorney fees and costs shall be paid out of the Common Fund from the reserves for Fees and Costs (see Paragraph 5A above). The Class Members shall be provided with notice of the amount

requested by Class Counsel for fees and costs and, along with the state, shall be provided with an opportunity to be heard on Class Counsel's Motion.

There is a dispute between the parties as to whether the State has standing to contest the reasonableness of Attorneys' Fees requested by Class Counsel because such fees will be paid from the tax refunds. The parties agree to submit this issue to the Court for determination of standing and whether the State has a right to contest fees.

Except as provided below, the amount awarded by the Court to Class Counsel shall be paid in approximately equal installments on or about the time the refund installments are paid to the class pursuant to Paragraph 9. If this Stipulation is finally approved, Class Counsel will be advanced the sum of $750,000 on **DECEMBER 1, 2002** and $750,000 on **JULY 7, 2003** to help defray their costs in implementing and administering this Stipulation. These advances will be credited against the amount due class counsel for its first installment payment.

15. SETTLEMENT ADMINISTRATION. The parties shall exchange information, subject to statutory and Internal Revenue Service confidentiality requirements, at regular intervals (in electronic format where practicable) concerning the claims process in order to permit status reports to be developed, trace class members, negotiate disputed claims and monitor Costs of Administration.

Within 45 days following each installment payment, the Department shall provide an accounting to the Court with a copy served upon Class Counsel. The Report will include the total number of class members who were sent refunds, the total refunds paid, the total number of opt-outs, an accounting of the reserves since the last report, the number of taxpayers and total refunds deposited into the Unclaimed Property Fund, the amount of Attorneys' Fees and Costs paid and a report of the Costs of Administration. The accounting will reflect both current activity and cumulative totals.

16. UNFORSEEN CIRCUMSTANCES. In the event either party identifies a major

problem with respect to the administration and processing of refunds as provided for herein, it shall immediately notify the other party of the facts and circumstances of the problem so identified. Notice to the class shall be sent to Class Counsel. Class counsel shall be responsible for distributing such notice to all other attorneys who have made an appearance in this action on behalf of a class member. Notice to the Department shall be sent to the Arizona Attorney General's Office, Chief Counsel Tax Section. The Department shall post any such notice that it sends or receives on its Internet website subject to confidentiality restrictions. In the event the parties are unable to reasonably resolve the problem, the parties agree that the problem will be submitted to the Court forthwith for final resolution as provided in Paragraph 27.

17. OBJECTIONS. At the final approval hearing, any member of the class, who has not opted out and who desires to submit an objection to this settlement, may appear personally or by counsel and show cause, if any, why the Stipulation should not be approved as fair, reasonable, adequate and in the best interest of the class or why the amount of attorney fees and costs requested by Class Counsel should not be approved and paid out of the the Common Fund from the reserves provided therefor. Unless the Court directs, no member of the class shall be heard or shall be entitled to contest any of these matters and no papers, briefs, pleadings or other documents submitted by any member of class shall be received and considered, except by rule of the Court for good cause shown, unless, no later than Date, the following documents have been signed pursuant to Rule 11, *Ariz.R.Civ.P.*, served and filed in the manner provided below:

a. Notice of Intention to Appear;

b. A detailed statement of such person's specific objections to any matter before the Court;

c. Proof of membership in the class; and

d. The grounds for such objections and any reasons why such person desires to appear and be heard, as well as all documents and writings which such person desires the Court to consider.

Such documents shall be filed with the Clerk of Court and served by mail or hand-delivery upon Class Counsel and the Attorney General's Office. Any objections filed and served in accordance with this procedure will be considered by the Court whether or not the objecting Class Member appears personally or by counsel at the hearing, provided that a notice of appearance is served and filed as hereinafter provided.

18. FURTHER PROCEEDINGS. In the event this Stipulation is not approved and a final order of approval entered thereon, the parties will be restored to their respective positions prior to the date of this Stipulation and this Stipulation shall be of no force or effect and the agreements reflected herein will be without prejudice to the parties' rights to maintain their respective positions concerning right of recovery or defenses thereto before the Court or in any appeal taken therefrom.

19. SETTLEMENT REPORTING. The Department will report refund settlement payments on Form 1099-G or such other form as required by the Internal Revenue Service. The Department agrees to seek advice from the Internal Revenue Service as to whether any amounts set aside for Attorney's Fees and Costs of Administration are reportable as taxable income by class members and therefore, whether or not they shall be included in the amounts reported. The Department shall agree to abide by any determination received from the Internal Revenue Service on this issue.

20. AUTHORITY. All persons executing the Stipulation and any of the exhibits hereto warrant and represent that they are fully authorized to enter into the terms and conditions of, and to execute such documents on behalf of their respective parties.

21. COUNTERPARTS. This Stipulation and its exhibits may be executed in one or more counterparts, all of which together shall be considered one instrument and all of which shall be considered duplicate originals

22. MODIFICATION; INTEGRATION. This Stipulation contains the parties' entire agreement with respect to the subject matter of this action. This Stipulation may be amended or modified only by written instrument signed by all the signatories hereto.

23. GOVERNING LAW. This Stipulation shall be governed by and construed in accordance with the laws of Arizona. Further, the parties understand and acknowledge that the ability of the Department of Revenue to process this settlement and administer the refunds pursuant to this agreement is contingent upon the appropriation of sufficient funding and authorization to spend by the Legislature.

24. FINALITY. The parties to this Stipulation intend it to be a final and complete resolution of all disputes asserted or which could have been asserted by Plaintiff or the members of the class against the Department with respect to the matter settled herein.

25. RECITALS. All recitals contained in this Stipulation are incorporated into and deemed to be part of the substantive provisions hereof as if fully set forth herein.

26. PARAGRAPH TITLES. The titles of paragraphs herein are for purposes of reference only and shall have no legal meaning or effect.

27. CONTINUING COURT SUPERVISION. Upon final approval of the Stipulation, it is agreed that the Court shall retain jurisdiction over this matter until the Department has fully performed all of its obligations hereunder. In addition, the Court may enter additional orders to effectuate the fair and orderly administration of the settlement as may from time to time be appropriate, including, *inter alia*, determination of persons to whom refund payments should be made in the event of death or marital dissolution. All parties to this Stipulation submit to the jurisdiction of the Court for such purposes.

Unless otherwise ordered by the Court, it will not be necessary for the parties to issue notice to individual class members with respect to problems subsequently resolved by the Court. It is agreed that the resolution of any problems of significance to the Class under this paragraph will be published on the Department's Internet website.

28. LATE PAYMENT. In the event that refunds cannot timely be made under the terms of this Stipulation because of failure of the Legislature to appropriate or authorize such spending, interest shall accrue from the date the installment payment was to be made until such payment is made. Such additional interest shall be paid without regard to any limitations that may be imposed by the Cap.

29. DISMISSAL. Upon the Department's performance of all its obligations hereunder and upon acceptance by the Court of the Department's final accounting, the parties agree that, upon motion of the Department, an order of dismissal with prejudice and without further costs may then be entered.

Attorneys for Plaintiffs

ARIZONA DEPARTMENT OF REVENUE

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APPROVED AS TO FORM:

JANET NAPOLITANO
Arizona Attorney General

By:
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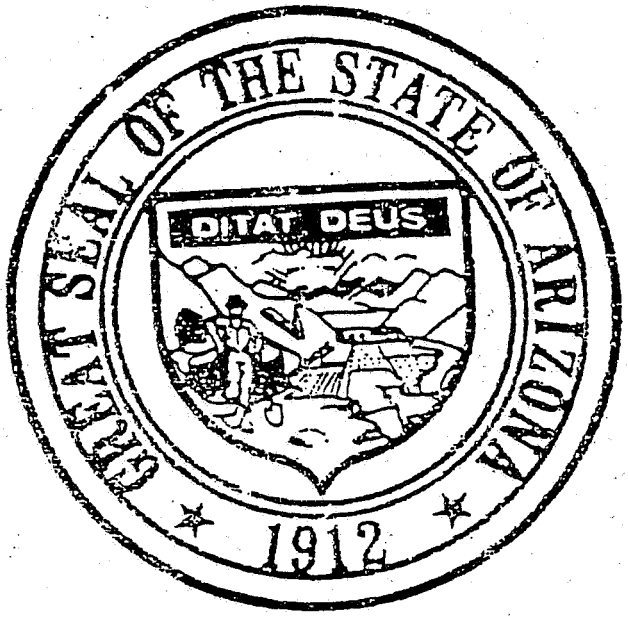

Arizona Department of Revenue

1994 Annual Report

Fife Symington
Governor

Harold Scott
Director

Federal Retiree Project

In March 1989, the U.S. Supreme Court's *Davis v. Michigan* decision declared that no state could give more favorable tax treatment to benefits from its own state and local governemnt retirement systems than to benefits from federal government retirement systems. On June 18, 1993, the U.S. Supreme Court made the *Davis* decision retroactive in its *Harper v. Virginia* decision. They further declared that the measure of retroactive relief must be determined in accordance with each state's tax laws.

By July 21, after an analysis of court decisions by the Arizona Attorney General's Office and the Department of Revenue, Governor Symington directed the department to take all necessary steps to make available the proper relief to all Arizona federal retirees who had timely claims.

Over the ensuing six months the department initiated a program resulting in credits and refunds to 40,754 retirees.

The relief project had to be accomplished without a tax increase. Therefore, it was determined that a credit voucher program, spreading the fiscal impact over four years, was the most feasible relief vehicle. Additionally, retirees who could not reasonably be expected to use the credit were issued refunds.

In four months, over 163,000 desk audits (more audits than the income tax unit normally performs in a year) were completed without adversely impacting the department's normal on-going "audit" or "compliance" program. This was accomplished by scheduling project work after normal hours and on weekends.

The project was completed with the department doing as much as possible for the claimants. Rather than requiring the retirees to file amended returns or calculate the amount of their credits or refunds, the department did virtually everything for the claimant. Only in those rare instances where there was insufficient information to process the claim was the taxpayer asked for input.

The success of the project is evidenced by the praise from the media, legislature, governor's office, and, most importantly, the federal retirees themselves. Of the 43,466 credit/refund determinations issued, only 1,402 have been protested. This is a true testament to the customer service orientation employees exercised in this project. The following details explain the project.

The Project

The project required the review of individual income tax returns of 44,502 claimants for tax years 1984 through 1989. The claimant universe of 44,502 was reduced to 43,466 cases after elimination of duplicate claims. Of these, 40,754 claimants actually received a refund or credit voucher. The difference, 2,712 claims, were invalidated. For example, the claimant may have been a retiree but not a federal retiree.

From available records, the department calculated the amount of overpayment for each year as well as the accrued interest. This determination was then sent to each claimant who was afforded the opportunity to appeal if there was a disagreement.

The majority of claimants received a credit voucher for the tax plus interest. These credits were available for application against the income tax liability for 1993 and subsequent years. Any balance remaining after paying the 1996 tax liability will be refunded. Credit balances will continue to accrue interest until they are used or refunded.

Those claimants who could not be reasonably expected to use the credit because they no longer live in the state, are deceased, or have adjusted gross income below the filing thresholds, received a refund.

The key pieces of the project— research, audit, systems, communication, support, and budget—are explained in greater detail below.

Research

Since the statute of limitations had expired, the first step was to create an account file of the 1984 through 1989 income tax returns for each claimant. Therefore, a total of 1,125,000 documents had to be reproduced from microfilm records and collated for an auditor's review.

Legibility of the microfilm W-2's was all too often marginal. In those instances retirement wage data was sought from the Department of Defense and OPM. The claimant was notified at this stage only if neither source was able to produce the necessary income information.

In order to handle the volume of microfilm files, the department obtained an additional thirteen microfilm reader/printers; eight were leased, three were borrowed, and two were purchased. Thirty-two temporary workstations were created. Crews worked two shifts, six days a week to complete this first phase by October 4, 1993, at a cost of $291,000.

As a result of the initial research and the general mailing, we learned that a number of claimants had moved or were not located. These claimants would not have received their refund or credit if it had not been for the efforts of the department's Skip Trace Unit, who found them. In total, 2,042 were found and brought into the program.

Audit

As claimant files were produced, they were routed to audit staff to make analyses and determinations. In addition to determining overpayments, auditors had to determine whether or not there was a death, divorce, or some other event that would

cause the claim to be split or redirected. Auditors also had to determine if any tax benefit issues came into play.

Auditors completed 163,655 reviews of tax years. Of the 43,466 credit/refund determinations issued, only 3.2 percent (1,402) were protested.

Systems

Department data processing systems were not structured for this kind of massive credit/refund project. Data processing systems had to be created or significantly modified to handle the audit, income processing, and tracking that this project required. In addition, a new system had to be developed interfacing the newly created credits with income tax processing.

New forms had to be designed, printed, and distributed. This included general information mailers, questionnaires, determination forms, self mailers, credit/refund statements, activity statements, and annual statements. All were designed with the intent of keeping the claimant informed.

Communication

The key to the customer service tone of this project was the communication with claimants. The department developed a communication plan that told the general public what we were doing, how the project would work, and kept all informed as the project progressed.

Since the claims had been filed as early as 1989, the first step was to communicate with every claimant at their last address of record. The department requested forwarding address information from the post office on this mailing so our records and future correspondence could use the claimant's latest address. From this, we were able to update 7,688 addresses, confirm marital status, and provide an opportunity for heirs and estates to make their claims.

Concurrently, an aggressive outreach communication program was undertaken involving print and electronic media. An informational video tape was produced for use by interested parties. A speakers bureau was established to speak to retirement groups. Every attempt was made to match a speaker's background to the audience. For example, a retired sergeant-major employee of the department spoke to the Retired Enlisted Men's Association. In total, 31 presentations were made to 1,609 retirees.

A separate Federal Employees Help Desk was established with its own telephone hotline, including toll free 800 service. This unit handled an average of 300 calls per day and is now fielding calls about how the credit will be used. By the end of the fiscal year, calls to the Help Desk totaled 39,731.

Practitioners were also informed through directed news releases, articles in the department's *TaxNews*, seminars, and workshops. The IRS was also briefed since the credit/refund might affect a claimant's federal filing. As a result, the IRS was able to prepare responses to taxpayers on what effect the credit/refund project would have on their federal filing requirements and train their taxpayer services personnel on this issue.

Support Budget

The normal personnel and equipment acquisition processes for this type of project would have been unsatisfactory for timely completion. Therefore, it was necessary to get approval for emergency procedures which allowed the department to initiate and complete the project in the very narrow window of time available.

Additional budget capacity was needed to complete the project within the four months allotted by the Governor because this project was not contemplated as part of the department's appropriated budget. The commitment and support by both executive and legislative leaders is exemplified by the $1.5 million supplemental appropriation the department received to complete the project.

Fiscal Year 1993/94 Cost

The cost in fiscal year 1993/94 of the Federal Retiree Project was $55,186,682. Federal retirees who had passed away, moved from the state, or no longer had a tax liability received refunds of $27,203,978. A total of $636,059 in credits was used to pay debts to other state agencies and to pay outstanding tax debts. Returns filed in the fiscal year claimed $27,346,645 of available credits. The total cost of the project is currently estimated to be $159.4 million, spread over five fiscal years.

Summary

In summary, this project required the close coordination of the legislative and executive branches of Arizona government, the commitment and capability of department employees, and the patience of the claimants. The result was the successful execution of a credit/refund program to over 40,000 federal retirees in compliance with the U.S. Supreme Court's decision in *Harper v. Virginia*.

The success of the project resulted in representatives from the National Association of Retired Federal employees saying, "If I were presenting awards for outstanding achievement in Government, the department would be a recipient," and Governor Symington declaring February 18, 1994, Federal Retiree Project Recognition Day. In addition, the team and DOR employee Tom McGinnis were winners in the 1994 Governor's Spirit of Excellence Award Program.

THE ARIZONA REPUBLIC
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EDITORIAL

Editorials represent the opinion of the newspaper, whose Editorial Board consists of: Phil Boas, Richard de Uriarte, Jennifer Dokes, Cindy Hernandez, Kathleen Ingley, Doug MacEachern, Joel Nilsson, O. Ricardo Pimentel, Robert Robb, Paul Schatt, Linda Valdez, Ken Western and Steve Benson.

Face the bitter music

Our stand: Lawmakers must focus session on budget fixes and avoid partisan battling

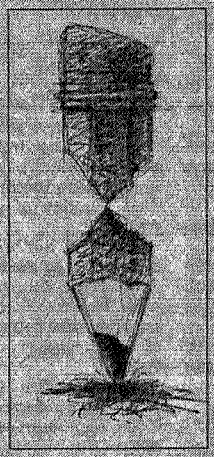
Gov. Jane Hull has called a desperately needed special session so the Legislature can patch the huge hole in the state budget.

Now lawmakers need to patch up their differences and do the job.

Recent news reports have shown a worrisome lack of consensus over measures to close the fiscal 2003 shortfall, now projected to be $500 million in a $6.2 billion budget.

As lawmakers gear up for Monday's special session, let's keep focused on what has to be done.

■ This is not the time for apathy. Some of the current legislators won't be back next year. But their responsibilities didn't end with the election. After all, they passed this budget in the first place. They owe it to their fellow Arizonans to go back and get it as much in balance as possible. Next year's Legislature will have enough problems with a projected billion-dollar gap in the fiscal 2004 budget.



■ This is not the time for speed over substance. Legislative leaders themselves suggested holding a one-day session. But that's not set in stone. They were banking on broad agreement on measures to fix at least half of the 2003 shortfall. Having Thanksgiving on the horizon was just one more spur to do the job quickly.

A speedy session would certainly be nice. But what's more important is to hold a productive session. So we urge lawmakers to be ready to come back the next week if necessary.

■ This is not the time for structural overhauls. A lame-duck Legislature is no place to reconsider how agencies are set up or whether to retool the K-12 educational system. One-time fixes, such as using some of the money set aside for settling the Ladewig tax lawsuit, should not be rejected out of hand.

■ This is not the time to shrink from bitter medicine. Arizona is in a crisis, and lawmakers must be ready to take the harsh steps that they would never consider in better times. No one wants to delay renovating the forensic facilities at the Arizona State Hospital, but that can save $10.4 million this year. Tapping special funds, like money earmarked for cleaning up underground storage tanks, means we give up or put off important tasks — but the budget crisis trumps them.

■ This is not the time to reject bonding. Lawmakers have been cool to the idea of borrowing money for school repairs. But right now, that's clearly the prudent move. A new cash-flow analysis shows that the money for the repair program, designed to bring all schools up to a minimum standard, will run out in January or February, leaving a shortage of $280 million. Not only would it be unconscionable to pull the plug on fixing our schools, it would be illegal. State law says all the repair projects must be under construction by next June and completed by June 30, 2004.

Missing the deadline would certainly trigger court action. If the program is stopped and then restarted, the added costs, including inflation, could run more than $40 million.

Given those risks, Hull's plan to borrow the money through revenue bonds is the wisest course for the long haul. Hull also suggests using bonds to raise an additional $100 million to bolster the general fund, a step that lawmakers should consider seriously.

This isn't the time to leave any stone unturned.

ARIZONA

Hull to call lawmakers into session on budget

By Elvia Diaz
The Arizona Republic

Gov. Jane Hull will call lawmakers into a special session Monday to deal with an estimated $500 million budget shortfall.

At best, however, lawmakers will consider reducing that amount by a little more than half.

The governor said she stepped in after lawmakers began murmuring this week that any cuts could wait until the new Legislature takes over in January.

"It's time for lawmakers to do their jobs," Hull said.

Legislators will spend today and Friday wrestling over specific cuts and hammering out exactly how much money to move around to reduce the deficit. It's clear, however, they aren't willing to consider the entire projected shortfall.

That means the incoming Legislature would have to do the necessary reductions to balance this fiscal year's budget, which ends in June, and deal with an estimated $1 billion shortfall for fiscal 2003-2004.

On Wednesday, Hull painted an even grimmer picture, saying money for school repairs and deficiencies is running out and that the budget shortfall will climb by another $300 million if lawmakers don't agree to borrow money for that purpose.

"That's crazy," Speaker of the House Jim Weiers said. "It not only delays the problem, it exacerbates it."

House majority Republicans, headed by Weiers, are proposing a $282 million plan to cut spending that includes $168 million in state agency cuts and money expected to be raised from the new tobacco tax. They also want to shift $114 million from specific programs or projects and delaying the renovation of a forensic facility.

Some Democrats in the evenly divided Senate are adamantly opposed to using money earmarked for such things as cleaning leaking underground fuel storage tanks.

They are also expected to offer a compromise to use at least $45 million set aside to reimburse residents who overpaid their out-of-state corporate dividends.

Weiers said no way.

Reach the reporter elvia.diaz@arizonarepublic.com or (602) 444-8948.

ARIZONA

State layoffs, reductions key in Senate budget plan

By Chip Scutari and Elvia Díaz
The Arizona Republic

Senate lawmakers moved closer to a budget-balancing plan Thursday that would eliminate more than 1,700 state jobs, slice about $120 million from state agencies and use $50 million from a new tobacco tax to help reduce Arizona's ever-mounting fiscal crisis.

The tentative deal, however, needs to be approved by the House of Representatives, whose members are more conservative and don't want to borrow to pay for school repairs. Gov. Jane Hull and key members of the Senate are pushing a plan to borrow nearly $390 million to repair public schools.

Hull has called legislators into a special budget session Monday to start the painful process of chopping $500 million out of the state's budget before June 30. Lawmakers are staring at a $1 billion deficit in the next fiscal year, which starts July 1.

Sen. Pete Rios, D-Hayden, said the number of possible pink slips is an unfortunate reality of budget cuts.

"I'm concerned anytime a person is laid off because lots of these folks are married with kids and they have bills to pay," Rios said. "Some of them have medical concerns and mortgages. That worries me."

Earlier this week, Hull said money for school repairs is running out and that next year's $1 billion budget shortfall will climb by an additional $300 million if lawmakers don't agree to borrow money for that purpose.

That idea probably won't fly in the House. House Speaker Jim Weiers, R-Phoenix, opposes borrowing any money and repaying it over time, saying that would eventually worsen the budget problem.

In the past, legislators have dipped into the school-repair fund, overseen by the state's School Facilities Board, to help balance the budget.

"We have to raise the money from somewhere," said Senate President Randall Gnant, a key sponsor of the school funding bill. "We can't keep just shifting money around forever."

Part of the Senate proposal includes using $45 million set aside to reimburse residents who overpaid their out-of-state corporate dividends. House leaders aren't keen on that idea because they will need the money to address the fiscal crisis in future years.

Meanwhile, House legislators, who are proposing a $282 million budget-cutting plan, will huddle today to consider cuts suggested by their Senate counterparts. House Democrats and Republicans will meet in separate sessions to mull specifics. Their package includes state agency cuts and shifting $114 million. Still unresolved between the two chambers is whether to delay the renovation of a forensic facility and how much will be cut from social services.

Despite the tough budget choices, Gnant said most Arizonans would not feel the impact of the budget cuts. At least for now.

"That's part of the problem in raising the general public's level of awareness of the financial situation," he said. "That will come next year."

What's next?

TODAY: House Democrats will meet at 11 a.m.; House Republicans will go over their budget plan at 2 p.m. They're working toward a one-day special session on Monday to take about a $280 million chunk out of an expected $500 million budget shortfall.

O'Neil, Cannon & Hollman, S.C.
ATTORNEYS AT LAW

PRIVILEGED SETTLEMENT COMMUNICATION PROTECTED BY RULE 408, ARIZONA RULES OF EVIDENCE

October 4, 2002

VIA FACSIMILE; ORIGINAL BY MAIL

Michael F. Kempner
1275 West Washington
Phoenix, Az 85007

Re: *Estate of Helen Ladewig v. Arizona Department of Revenue*

Dear Mr. Kempner:

We are already starting to receive inquiries from class members with respect to the implementation of the settlement. These inquiries have also resulted in the identification of two recurring themes, which we believe should be addressed immediately by the Department. Our suggestion is that the Department frame answers to frequently asked questions and post them on the Department's website. We, in turn, will reproduce those same questions and answers on our website.

The first line of inquiry relates to divorce. The general question is: "What documentation, if any, will I be required to file since the entitlement to refunds is entirely mine under a final decree of divorce?" The related question is: "What steps do my ex-wife and I have to take in light of the fact that we will share the refund pursuant to a percentage specified in a divorce decree?"

The other significant line of questions results from a whole variety of opportunities that are now available, under various state laws, to simplify the administration of estates. The questions that we have encountered involve a variety of issues. For example, "What documentation do we need to file, in view of the fact that when my mother died everything went to my father by operation of law and, later, when my father subsequently died everything passed to the children by informal administration – without probate?" A variation of this question is the use of a Washington Will under various state laws to avoid the need for probate. A slightly different variation arises in the context of decedents, who, before their death, assigned all of their property to some form of revocable living trust with the result that there was no probate proceeding.

Related to all of the above questions is the related question of what steps the beneficiaries, spouses, and ex-spouses, as the case may be, should take to ensure that they receive a notice so as to avoid the necessity of filing the separate claim form.

In view of the importance of these issues and their significant impact upon the Department's ability to function efficiently in implementing the settlement, it is requested that this receive the immediate attention both of your office and the Department.

Thank you for your prompt attention to this matter.

Very truly yours,

Eugene O. Duffy

EOD:bab

cc. Paul V. Bonn (Via fax and mail)
Randall D. Wilkins (Via fax and mail)
D. Michael Hall (Via fax and mail)
Brian A. Luscher (Via fax and mail)
Dennis Graves (Via fax and mail)

O'Neil, Cannon & Hollman, S.C.
ATTORNEYS AT LAW

PRIVILEGED SETTLEMENT COMMUNICATION PROTECTED BY RULE 408, ARIZONA RULES OF EVIDENCE

November 1, 2002

VIA FACSIMILE; ORIGINAL BY MAIL

COPY

Michael F. Kempner
1275 West Washington
Phoenix, Az 85007

Re: *Estate of Helen Ladewig v. Arizona Department of Revenue*

Dear Mr. Kempner:

This letter is intended to follow up on our correspondence to you of October 4, 2002. We continue to receive inquiries from class members as to the documentation that the Department may require in cases where there has been a divorce, legal separation or death. We note that some guidance has been provided in the instructions to the Department's claim form regarding survivors of deceased class members. We again request that the Department provide us guidance as to whether or not that guidance is equally applicable to class members who received the notice and who are already in the class? In addition, we also request guidance for cases involving a divorce or legal separation.

Second, we inquire as to the status of the Department's undertakings with respect to Paragraph 4 of the Stipulation of Settlement. We have monitored CCH, BNA and State Tax Notes and have found no mention of the Stipulation of Settlement or the Court's preliminary approval thereof. We request being advised of the steps taken to date by the Department to disseminate the information as required by Paragraph 4 of the Stipulation of Settlement.

Third, we are also interested in the success of the individual notice process. Please provide us with an estimate of the number of notices that have been returned as undeliverable and the steps being taken by the Department to correct and re-mail such notices.

Thank you for your prompt attention to these matters.

Very truly yours,

Eugene O. Duffy

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Randall D. Wilkins (Via fax and mail)
D. Michael Hall (Via fax and mail)

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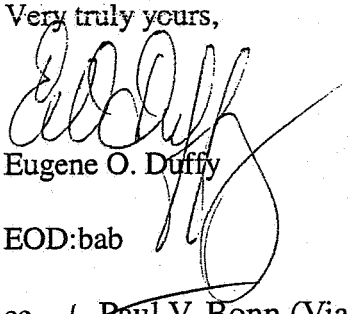

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